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TAXATION OF IMPORTED OIL

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 27 AND 28, 1986

Printed for the use of the Committee on Finance

ORIGINAL

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TAXATION OF IMPORTED OIL

THURSDAY, FEBRUARY 27, 1986

U.S. Senate,
Committee on Finance,
Subcommittee on Energy and Agricultural Taxation,
Washington, DC.

The committee met, pursuant to notice, at 9 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman) presiding.

Present: Senators Chafee, Wallop, Symms, Grassley, Long, Bentsen, Boren, Bradley, and Mitchell.

[The press release announcing the hearing and the prepared written statements of Senators Wallop, Chafee, Bentsen, Boren, and Mitchell and a pamphlet explaining taxation of petroleum imports by the Joint Committees on Taxation follow:]

[Press Release No. 86-004, Wednesday, January 29, 1986]

Taxation of Imported Oil To Be Considered by Finance Committee's Energy Subcommittee

The Senate Committee on Finance's Subcommittee on Energy and Agricultural Taxation has scheduled two days of hearings to review proposals to tax imported oil, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the Subcommittee would hear arguments for and against the oil import issue Thursday, February 27, and Friday, February 28, 1986.

Senator Malcolm Wallop (R-Wyoming), Chairman of the Subcommittee on Energy and Agricultural Taxation, will preside at the two days of hearings.

Both hearings are scheduled to begin at 9 a.m. in Room SD-215 of the Dirksen Senate Office Building in Washington.

The hearings will specifically review two bills:

S. 1997, introduced by Senator Wallop on December 19, 1985, the bill would amend the Internal Revenue Code of 1954 to impose a tax on the importation of crude oil and refined petroleum products.

S. 1507, introduced by Senator David Boren (D-Oklahoma) on July 26, 1985, the bill would increase the tariff on imported crude oil and refined petroleum products.

STATEMENT OF SENATOR MALCOLM WALLOP
CHAIRMAN OF THE ENERGY AND AGRICULTURAL TAXATION SUBCOMMITTEE
OF THE SENATE FINANCE COMMITTEE
FEBRUARY 27, 1986

GOOD MORNING. I WANT TO THANK, IN ADVANCE, THE MANY EXPERT WITNESSES WHO HAVE TAKEN TIME TO APPEAR BEFORE THIS COMMITTEE AND PARTICIPATE IN WHAT I EXPECT WILL BE A LIVELY DISCUSSION ON THE MERITS AND POTENTIAL PROBLEMS OF AN OIL IMPORT FEE.

LET ME BEGIN THIS HEARING BY MAKING ONE POINT PERFECTLY CLEAR: IT IS MY STRONG BELIEF THAT ENERGY TAXATION DISCUSSED WITHIN THE CONFINES OF TAX REFORM AND DEFICIT REDUCTION IS NOT A RATIONAL APPROACH. AN ENERGY TAX IN EITHER OF THESE FORMS, WILL FAIL TO ACHIEVE REAL DEFICIT REDUCTION OR GENUINE TAX REFORM AND WILL NEGLECT ENERGY POLICY.

AS I'VE REPEATEDLY SAID SINCE SENATOR BENTSEN AND I INTRODUCED S. 1997, I AM NOT YET CONVINCED THAT AN ENERGY EXCISE TAX IS THE ONLY, OR EVEN THE MOST APPROPRIATE COURSE TO TAKE. IT IS THE PURPOSE OF THESE HEARINGS TO DETERMINE JUST THAT.

IF THERE IS MERIT TO AN OIL IMPORT FEE OF ANY DESCRIPTION, THERE IS ONLY ONE CHOICE IN MY MIND AND IT IS NOT THE FLAT TAX ADVOCATED BY SOME OF MY COLLEAGUES. RATHER, IT IS THE FLOATING FEE APPROACH TAKEN IN S. 1997. THOUGH THERE WOULD BE SOME EFFECT, THIS FLOATING TAX CANNOT BE DUBBED A REVENUE-RAISER BECAUSE IT WOULD NEVER PROVIDE TREASURY WITH A CONSTANT AND PRE-DETERMINED SOURCE OF REVENUE. FURTHERMORE, THE TAX WOULD AUTOMATICALLY PHASE OUT WHEN THE WORLD PRICE OF OIL HITS THE BILL'S SURVIVAL PRICE. MOST IMPORTANTLY, IT WOULD PROVIDE A SOURCE OF STABILITY FOR OUR DOMESTIC ENERGY PRODUCERS, INCLUDING COAL, RENEWABLES AND CONSERVATION.

IT IS MY HOPE THAT THE ARGUMENTS EXPRESSED TODAY AND TOMORROW WILL RECEIVE CAREFUL CONSIDERATION FROM MY COLLEAGUES, AND THAT THE SENATE WILL NOT CHOOSE AN ENERGY TAX AS SOME SIMPLE NARCOTIC TO RELIEVE THE IMMEDIATE AND NAGGING PAINS OF TAX REFORM OR DEFICIT REDUCTION. IT WOULD ONLY SERVE AS TEMPORARY RELIEF WITH SERIOUS, LONG-LASTING RIPPLE EFFECTS FROM WHICH FUTURE GENERATIONS WOULD SURELY SUFFER. IN CALLING FOR THESE HEARINGS, MY PURPOSE WAS, AND IS, TO IDENTIFY THE ENERGY POLICY ARGUMENTS SURROUNDING ANY POTENTIAL JUSTIFICATION AND CONSEQUENCE OF IMPLEMENTING AN OIL IMPORT FEE.

RIGHT NOW, THESE HEARINGS ARE IRONICALLY TIMELY IN LIGHT OF THE PRECIPITOUS DROP IN WORLD OIL PRICES WHICH HAS BROUGHT NEW OPPORTUNITIES, PROBLEMS AND EVEN MIXED BLESSINGS FOR OUR NATION AND FOR MY HOME STATE OF WYOMING. IF I SIT QUIETLY IN MY OFFICE, IT'S POSSIBLE TO HEAR ALL THE WAY FROM WYOMING, THE JOYFUL WHOOPS AND HOLLERS FROM RANCHERS NOW EXPECTING PRICE RELIEF IN ONE OF THEIR BIGGEST FIXED COSTS. AND, MY STATE, WHICH PRODUCES AND CERTAINLY CONSUMES ENERGY, IS ALREADY OPTIMISTIC THAT POTENTIALLY LOW GASOLINE PRICES THIS SUMMER WILL BOOST OUR SAGGING ECONOMY BY BRINGING MORE VISITORS TO YELLOWSTONE AND GRAND TETON NATIONAL PARKS.

ON THE OTHER HAND, WYOMING, LIKE EVERY ENERGY-EXPORTING STATE, HAS SUFFERED DRAMATICALLY FROM FALLING OIL PRICES. A CASPER OIL MAN RECENTLY POINTED OUT TO ME AS A GENERAL RULE OF THUMB, THAT FOR EVERY $1.00 DECREASE IN THE PRICE OF CRUDE, MY STATE AT ALL LEVELS SUFFERS AN INCOME LOSS OF $15 MILLION PER YEAR IN AD VALOREM TAXES, SEVERANCE TAXES, STATE ROYALTY AND FEDERAL ROYALTIES.

THE OTHER BOOT DROPS AS A RESULT OF LESS MONEY TO DRILL NEW WELLS, WHICH TRANSLATES INTO LEANER REVENUES, FEWER JOBS AND A FURTHER SAG IN OUR ALREADY AILING ECONOMY. OTHER ENERGY RESOURCES SUFFER TOO. WYOMING HAS SUBSTANTIAL OIL, NATURAL GAS AND COAL RESERVES. AS OIL, THE GOLD STANDARD OF THE "BTU" BUSINESS DROPS, SO DOES THE VALUE OF COAL AND NATURAL GAS, AS WELL AS INTEREST IN EMERGING, YET EXPENSIVE, PROJECTS SUCH AS ENHANCED OIL RECOVERY, COGENERATION, AND EVEN CLEAN COAL TECHNOLOGY.

I HAVE BEEN A STUDENT OF ENERGY POLICY FOR MANY YEARS. I HAVE STUDIED THE VARIOUS TOOLS FOR ASSURING AMERICANS AN INDEPENDENT ENERGY SUPPLY. AFTER REFLECTION, I WOULD GENERALLY CONCLUDE THAT TAXES ON ENERGY CONSUMPTION ARE UNGAINLY TOOLS FOR IMPLEMENTING A RATIONAL ENERGY POLICY. DEVELOPMENT AND CONSERVATION TAX INCENTIVES, ALONG WITH AN EMERGENCY SUPPLY PROVIDED BY THE STRATEGIC PETROLEUM RESERVE SEEM BETTER METHODS OF ASSURING ENERGY SECURITY AND MARKET VIABILITY.

SOME MIGHT SAY THAT AN OIL IMPORT FEE IS JUST ANOTHER ATTEMPT TO SMOTHER FREE MARKET FORCES FROM COMING INTO PLAY. THIS MAY BE ONE CONCERN THAT WE WILL EXPLORE TODAY. AS WE ALL RECALL, GOVERNMENT EFFORTS TO PREVENT FREE MARKET FORCES FROM ESTABLISHING OIL PRICES BEGAN IN EARNEST IN THE EARLY 1970S, AS THE OPEC CARTEL CAME TO DOMINANCE. IN A RAGE, CONGRESS IMPOSED THE WINDFALL PROFITS TAX WHICH ASSURED THAT THE FREE MARKETS WOULD NEVER REALLY OPERATE.

SOME MEMBERS WHO NOW ASSERT THAT THE NEW LOWER PRICES SHOULD NOW BE PASSED COMPLETELY ON TO THE CONSUMER ARE THE SAME ONES WHO IMPOSED THE WINDFALL PROFITS TAX WHICH DEPRIVED THOSE SAME CONSUMERS OF $77 BILLION IN ENERGY SAVINGS OVER THE COURSE OF ITS EXISTENCE. THEY MAY ALSO BE THE ONES WHO CONTINUE TO IMPOSE OTHER SPECIAL TAXES ON ENERGY LIKE SUPERFUND AND BLACK LUNG. CONGRESS HAS, OVER THE YEARS, DEALT IN HARSH INCONSISTENCIES WITH THE ENERGY INDUSTRY AND THE AMERICAN CONSUMER HAS CONTINUALLY PAID THE PRICE.

IN SPITE OF OURSELVES, WE HAVE MADE TREMENDOUS STRIDES IN REDUCING OUR RELIANCE ON FOREIGN OIL, ON CONSERVING ENERGY IN OUR HOMES AND INDUSTRIES. STILL, WE ARE TRAVELING TOWARD THE TWENTY FIRST CENTURY WITHOUT AN ENERGY POLICY THAT IS EITHER FAR-SIGHTED OR COHESIVE. WHAT WE HAVE HAS BEEN DEVELOPED IN DRIPS AND DRABS, AT THE WHIMS OF INDIVIDUAL MEMBERS OF CONGRESS AND BY 45 OR SO DIFFERENT GOVERNMENT BODIES.

THE INCONSISTENCIES IN CONGRESSIONAL ENERGY POLICY ARE WELL DOCUMENTED AND TRULY OUTRAGEOUS -- WE HAVE BEEN IN AND OUT OF NATURAL GAS, FIRST REGULATING AND PARTIALLY DEREGULATING IT. WE'VE BEEN IN AND OUT OF SYNFUELS -- FIRST FUNDING IT AND THEN DRAINING IT AWAY. TODAY, WE ARE ON EQUALLY DANGEROUS GROUND AND I TRUST WE WILL ALL TREAD CAREFULLY. AS WE AGAIN CONSIDER THE TAXATION OF ENERGY I CHALLENGE CONGRESS TO CONSISTENCY -- AND I DOUBT CONGRESS WILL LIKE IT. ONE CAN NO MORE MAKE REVENUE POLICY WITHOUT REGARDS TO THE ULTIMATE CONSEQUENCE THAN ONE CAN MAKE ENERGY POLICY WITH ONLY REVENGE IN THE HEART.

STATEMENT OF
SENATOR JOHN H. CHAFEE
BEFORE THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE FINANCE COMMITTEE
FEBRUARY 27 AND 28, 1986

First, I would like to thank Senator Wallop for calling these hearings on the taxation of petroleum imports. I am very anxious to have the committee examine the various proposals so that we can see just how bad they all are. Whether an oil import fee is structured as a flat dollar fee on an imported barrel of oil or a floating fee designed to keep a "floor" under the price of oil, I am opposed to it. These proposals are a bad idea for Rhode Island, for New England, and for the national as a whole.

If I were to propose a bill requiring the citizens of Oklahoma, Texas and Louisiana to pay 5 percent higher federal taxes than citizens in other states, the cries of furor would roll like thunder across Capitol Hill. Yet that is precisely what advocates of an oil import fee are proposing for the citizens of my state and

New England as a whole: taxes higher than citizens anywhere else in this land will have to pay. I am outraged, and will fight thisinfamous scheme with everything I have.

An oil import fee, first of all, is simply unfair. New England leads the nation in energy conservation, but we still depend on oil for fully two-thirds of our energy needs: a figure which is nearly double the national average. Because an oil import fee would raise the cost of all petroleum products, foreign or domestic, it would deal a savage blow to the homeowners and businessmen of my state.

The average citizen of my state now pays over $1,000 dollars a year to heat a home with oil, while a homeowner in Ohio typically pays only $800 dollars a year to heat his house with natural gas. A $10 oil import fee could raise a Rhode Islander's annual fuel bill by nearly $240 dollars. It is unfair to New Englanders to bear the brunt of such higher costs for such a basic commodity as oil.

AN OIL IMPORT FEE IS UNFAIR TO BUSINESSES AS WELL AS HOMEOWNERS. MAINTAINING ARTIFICIALLY HIGH DOMESTIC ENERGY COSTS, THROUGH AN IMPORT FEE, WOULD ERASE ANY COMPETITIVE ADVANTAGE OUR RECOVERING INDUSTRIES HAVE GAINED IN THE LAST FEW YEARS. WE HAVE JUST SEEN OUR WAY THROUGH A DIFFICULT ECONOMIC RECESSION. MANY INDUSTRIES, SUCH AS MANUFACTURING, ARE STILL STRUGGLING, AND FOREIGN COMPETITION GETS TOUGHER BY THE DAY. DO WE REALLY WANT TO COMPOUND OUR TRADE PROBLEMS WITH AN OIL IMPORT FEE? IN RHODE ISLAND, WHERE OUR INDUSTRIES ALREADY PAY MORE FOR ENERGY THAN ANY OTHER STATE, THE EFFECTS OF THE FEE COULD BE DEVASTATING -- ENDANGERING THOUSANDS OF JOBS AND PRICING OUT PRODUCTS OUT OF WORLD MARKETS.

SECOND, AN OIL IMPORT FEE IS A COMPLETELY INEFFICIENT WAY OF RAISING REVENUE. SUCH A FEE, BY DEFINITION, WOULD NOT APPLY TO DOMESTIC OIL COMPANIES, YET DOMESTIC OIL PRICES WOULD CERTAINLY RISE TO THE PRICE OF IMPORTED OIL. WITH A $10 PER BARREL IMPORT FEE, U.S. CONSUMERS WOULD PAY $58 BILLION MORE EACH YEAR IN ADDITIONAL ENERGY COSTS, BUT THE FEDERAL GOVERNMENT WOULD COLLECT LESS THAN $16 BILLION IN ADDITIONAL TAXES.

The reason for this inefficiency is simple. Imported oil makes up approximately 28 percent of all oil, but the oil import fee would cause the price of all oil to increase. However, for every dollar of increase in the price of all oil, the federal government would collect only 28 cents.

We might actually realize more revenue from an expanding economy if oil prices were to fall to sustained low levels. Some economists have stated that for every $5 the price of oil drops, the consumer price index will fall 1 percent, and the GNP will grow .6%. If we intervene to artificially keep the price of oil high by imposing an oil import fee, the federal government will lose any revenues that might flow from the increased growth in the economy caused by the falling energy costs.

Lower energy costs can mean lower inflation, an increase in per capita income, and more jobs for ALL American. Let's not intervene to keep this from happening.

Most economists agree that an oil import fee is a bad idea. The NATIONAL ASSOCIATION OF BUSINESS ECONOMISTS just announced that they oppose an oil import fee. Earlier this month, I personally

ASKED FOUR ECONOMISTS - MARTIN FELDSTEIN, CHARLES SCHULTZE, NORMAN TURE AND ALAN AUERBACH - WHO WERE APPEARING BEFORE THIS COMMITTEE ON ANOTHER MATTER, ABOUT AN OIL IMPORT FEE. THEY DID NOT AGREE ON MUCH IN THEIR TESTIMONY, BUT THEY ALL AGREED THAT THE OIL IMPORT FEE IS BAD ECONOMIC POLICY, AND THEY ALL AGREED THAT IF WE LET THE PRICE OF OIL FALL, IT WILL BE GOOD FOR THE ECONOMY.

THE FEDERAL RESERVE CHAIRMAN, PAUL VOLCKER, HAS ALSO STATED THAT HE OPPOSES AN OIL IMPORT FEE. I HOPE WE WILL HAVE TESTIMONY TODAY FROM OTHERS WHO AGREE WITH ALL THESE EXPERTS.

FINALLY, AN OIL IMPORT FEE MAKES A MOCKERY OF TAX REFORM. IT'S BEING PROPOSED AS A WAY TO RAISE REVENUE TO FINANCE THE CONTINUATION OF LOOPHOLES WHICH THE COMMITTEE EVIDENTLY LACKS THE COURAGE TO CLOSE. THESE LOOPHOLES INCLUDE TAX "INCENTIVES" FOR THE OIL INDUSTRY SUCH AS EXPENSING OF INTANGIBLE DRILLING COSTS AND PERCENTAGE DEPLETION. TO OBTAIN A REDUCTION IN RATES, A NEW TAX IS PROPOSED. RIDICULOUS. ANY ADDITIONAL REVENUE FROM NEW TAXES SHOULD BE ALLOCATED TO REDUCING THE DEFICIT, NOT TO FINANCING CONTINUED TAX BREAKS. WE SHOULD NOT BE INCREASING ENERGY COSTS TO ALL CONSUMERS IN ORDER TO "PAY" FOR TAX INCENTIVES AVAILABLE TO THE PRIVILEGED FEW.

If the committee or the Senate itself insists upon including this unfair and damaging proposal in a tax reform bill, I will do everything within my power to resist it. Now that the price of oil is finally declining, the American consumer should be allowed to benefit.

STATEMENT BY
Senator Lloyd Bentsen
Senate Finance Committee Hearings
Oil Import Fee
Thursday February 27, 1986

If we learned anything from the Arab oil embargo of 1973 it's that we cannot afford to get hooked on foreign oil again.

We are the world's biggest consumer of oil, far ahead of everyone else.

We are also a big producer of oil; 8.9 million barrels a day last year, roughly twice the production of Saudi Arabia, even after their recent boost in output. We are second only to the Soviet Union in oil production.

I'll guarantee you, though, that you'll see U.S. oil production decline this year. The only question is how far.

We've already seen marginal wells start shutting down because it is no longer economical to continue pumping. And once you lose one of those small wells, chances are the reservoir will collapse and it'll be gone forever.

We've pumped a lot of oil in this country but, remarkably, our proved reserves were more than 6 billion barrels higher two years ago than they had been in 1949. That's because of the continuing search for new oil and the development of sophisticated — and expensive — techniques for squeezing more oil out of existing wells.

The search for new oil has declined sharply in recent years, though. Half as many wells were drilled last year as in the peak year of 1982, and that number will plummet this year. Yesterday, for example, Amoco announced it will cut spending on exploration in 1986 by $1 1/2 billion.

Our proved reserves are already down from two years ago, since they included some 2 1/2 billion barrels of oil that could be recovered only through enhanced techniques that were economical at existing prices.

And the decline in exploration guarantees a further decline in reserves two and three and four years from now.

And you can forget about alternative energy sources. You can forget about converting coal to oil. Shale oil is out the window. The Great Plains gasification project in North Dakota has been described as a disaster.

We've made great strides in energy conservation and energy production in recent years, but you can forget all that if we fail to respond to the flood of cheap oil from OPEC.

What's happening to oil prices today has nothing to do with the free market. It has everything to do with a decision made in Riyadh. An OPEC decision. They turned the spigot off in the Arab embargo of 1973 and they opened it several extra turns in the production wars of 1985.

Does anyone here believe that Saudi Arabia is driving down the price of oil because they want to keep it down? Of course not. What they're trying to do is whip other OPEC members in line and other producers around the world.

Are our memories so short that we're going to once again put ourselves at the mercy of OPEC?

Last year we imported only 31% of the oil we used, compared with 47% in 1977. That pendulum will start swinging back this year. There's no way to stop it, the price plunge has already assured it. We can, though, slow it and begin the process of turning it back around.

Last year we imported only 1.7 million barrels of oil a day from OPEC, compared with 6.1 million barrels in 1977. That pendulum, too, will start swinging back this year.

Our oil refiners in this country have been buffeted by a combination of circumstances in recent years. Oil producing countries give subsidies to their own refiners and Europe and Japan put up barriers to those refined products, so they've been flooding into the U.S. As a result, we've seen operating refining capacity decline in this country by 3 1/2 million barrels a day since 1981. A study last year, by the Center for Strategic and International Studies at Georgetown University, concluded that our remaining 14.6 million barrel a day refining capacity is not enough to "respond to a military mobilization involving U.S. and NATO forces."

If we fail to respond to the flood of cheap OPEC oil, by putting an oil import fee in place, there's no question but what we will soon see the same serious national security implications develop with regard to oil production that we have already seen for refining.

Plunging oil prices have produced a gusher of optimistic economic projections for coming months.

But we, as a nation, ought to be able to see at least to the end of our nose. We ought, also, to be able to look backward far enough and recall the last time we were hooked on foreign oil,then take rational steps to prevent that from happening again.

-30-

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

STATEMENT OF
UNITED STATES SENATOR DAVID BOREN

FEBRUARY 27, 1986

MR. CHAIRMAN:

I WOULD LIKE TO THANK YOU FOR THE OPPORTUNITY TO PARTICIPATE IN THESE MOST IMPORTANT HEARINGS. I CERTAINLY AGREE WITH YOUR EARLIER STATEMENTS THAT WE MUST MOVE TO TAKE ADVANTAGE OF OUR CURRENT ENERGY PLANNING OPPORTUNITIES, AND HONOR OUR RESPONSIBILITY TO PROVIDE FOR AMERICA'S FUTURE ENERGY SECURITY.

OUR PRIMARY GOAL HAS BEEN TO PLACE A SAFETY NET UNDER THE PRICE OF DOMESTIC OIL THAT WOULD ALSO PROTECT THE FINANCIAL SYSTEM AGAINST THE SHOCK OF FURTHER DECREASES IN THE PRICE OF OIL. THE VALUE OF OIL RESERVES IS USED AS SECURITY FOR BILLIONS OF DOLLARS IN LOANS HELD BY AMERICAN BANKS. SOME ANALYSTS HAVE ESTIMATED THE TOTAL DOMESTIC DEBT TO POTENTIALLY RIVAL THAT AMOUNT LOANED OUT TO FOREIGN OIL PRODUCING COUNTRIES SUCH AS MEXICO AND VENEZUELA. SHOULD THE PRICE OF OIL STAY BELOW $20 PER BARREL, AS MORE AND MORE ANALYSTS ARE PREDICTING, THE STABILITY OF THE BANKING AND FINANCIAL SYSTEM IN OIL PRODUCING REGIONS OF THE COUNTRY WILL BE THREATENED. IT IS ONLY A MATTER OF TIME UNTIL THOSE DIFFICULTIES SPREAD TO MONEY CENTERS LIKE NEW YORK AND CHICAGO. IT IS INTERESTING TO NOTE THAT AS A RESULT OF THE RECENT DRAMATIC DROP IN THE PRICE OF OIL, LOSSES TO THE FEDERAL DEPOSIT INSURANCE CORP. ON POOR LOANS IT ACQUIRED FROM CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COULD EXCEED $1.5 BILLION. THE FDIC ONLY HAS $22 BILLION IS ASSETS AND IF ONE MID-SIZED ENERGY RELATED BANK FAILURE

CAN CAUSE $1.5 BILLION LOSSES, WHAT WILL HAPPEN IF TWO OR THREE LARGE REGIONAL BANKS ARE FORCED UNDER?

THERE ARE THOSE WHO ARGUE THAT AN OIL IMPORT FEE WOULD SLOW ECONOMIC GROWTH, COST THE ECONOMY JOBS, AND CAUSE INFLATION TO INCREASE BY AS MUCH AS 12 PERCENT. WHAT OPPONENTS OF A FEE FAIL TO CONSIDER IS THE DISRUPTION THAT WILL OCCUR IN OUR ECONOMY IN THE LONG RUN AS A RESULT OF THIS FORCED DECREASE IN THE PRICE OF OIL. WE ARE NOT WITNESSING A NORMAL SUPPLY AND DEMAND MARKET REACTION. WE ARE CAUGHT IN THE MIDDLE OF A LIFE AND DEATH STRUGGLE FOR MARKET SHARE. UNFORTUNATELY BECAUSE MOST FOREIGN OIL COMPANIES ARE CLOSELY TIED TO THEIR GOVERNMENTS THEY WON'T MAKE NORMAL "ECONOMIC" DECISIONS. AS THE PRICE OF OIL APPROACHES THE COST OF PRODUCTION THOSE PRODUCERS WHO DON'T BENEFIT FROM FAVORABLE GOVERNMENT POLICIES WILL BE THE FIRST TO PLUG THEIR PRODUCTION. SHOULD THE PRICE OF OIL STABILIZE AROUND THE $15 PER BARREL LEVEL, DRILLING EXPENDITURE IN THE U.S. WILL DROP BY 50 PERCENT. THE IMMEDIATE IMPACT IS, OBVIOUSLY, LOST JOBS IN THE OIL AND GAS AND RELATED INDUSTRIES. SOME ESTIMATES HAVE RANGED AS HIGH AS 600,000 JOBS. MORE IMPORTANTLY, THOUGH, IT MEANS FEWER WELLS WILL BE DRILLED NEXT YEAR AND THAT TRANSLATES INTO THE NEED TO IMPORT MORE CRUDE OIL AND PETROLEUM PRODUCTS, ALMOST $9 BILLION IN ADDITIONAL IMPORTS - NEXT YEAR ALONE!

I HAVE OFTEN SAID THAT IF THE LEADERS OF OPEC REALLY WANTED TO GAIN TOTAL CONTROL OF THE MARKET, THEY WOULD DROP OIL PRICES BELOW OUR LIFTING COSTS WHICH INCLUDING TAXES RANGE FROM $12 TO $18. THEY WOULD THEN KEEP THE PRICE OF OIL AT THAT LEVEL JUST LONG ENOUGH TO DESTROY THE BASIC ENERGY INDUSTRY INCLUDING THE SUPPLY AND SERVICE INDUSTRIES INFRASTRUCTURE. THEY COULD THEN BE IN A POSITION TO RAISE THE PRICE OF OIL TO UNREASONABLY HIGH LEVELS, SHOULD THEY CHOOSE TO DO SO, BECAUSE WE WOULD BE TOTALLY DEPENDENT. THINK OF WHAT THAT WOULD DO TO OUR NATIONAL SECURITY INTEREST. CONSIDER WHAT THAT WOULD MEAN TO AMERICAN CONSUMERS. I THINK THOSE CONSUMERS WOULD BE DEMANDING TO KNOW THE NAMES OF THE SHORT-SIGHTED MEMBERS OF CONGRESS WHO ALLOWED US TO FALL INTO OPEC'S TRAP.

SURELY WE HAVE NOT SO QUICKLY FORGOTTEN THE LESSONS OF EVEN RECENT HISTORY. DURING THE ENERGY CRISIS OF THE 1970'S WE LEARNED WHAT CAN HAPPEN WHEN WE BECOME OVERLY DEPENDENT ON FOREIGN SOURCES OF OIL. ONCE THE FULL IMPACT OF FALLING OIL PRICES IS PASSED THROUGH TO CONSUMERS, I HAVE NO DOUBTS THAT CONSUMPTION WILL BEGIN TO RISE AGAIN. PERHAPS SLOWLY AT FIRST, BUT IT IS ONLY A MATTER OF TIME UNTIL WE WILL AGAIN BE IMPORTING OVER 50 PERCENT OF OUR ENERGY NEEDS FROM FOREIGN SOURCES. THEN AS THE GROWING DEMAND FOR OIL REDUCES THE CURRENT OVERSUPPLY, WE WILL ONCE AGAIN BE CAUGHT IN A SUPPLY CRUNCH SO REMINISCENT OF THE 1979 CRISIS. WE SHOULD ALSO REMEMBER THAT RESTORING DOMESTIC PRODUCTION CAPABILITY AFTER

IT IS DESTROYED IS NOT AS SIMPLE AS TURNING ON A WATER FAUCET. IT TAKES YEARS OF LEAD TIME, SOMETHING WE HAVE NOW BUT MAY FORFEIT SHORTLY.

THE IMPACT OF AN IMPORT FEE EVEN IF PASSED DIRECTLY THROUGH TO THE CONSUMERS WOULD BE MINIMAL. IN 1979 THE AVERAGE PRICE FOR A GALLON OF GASOLINE WAS 88.2 CENTS. TO BUY THAT SAME GALLON OF GASOLINE WITH CURRENT DOLLARS WOULD COST YOU $1.25. CURRENTLY, IN OKLAHOMA YOU CAN BUY A GALLON REGULAR UNLEADED GASOLINE FOR LESS THAN 90 CENTS. SO YOU CAN SEE THE REAL COST OF ENERGY HAS ACTUALLY DROPPED OVER THE PAST SIX YEARS. EVEN IF THE FULL COST OF AN IMPORT FEE WERE PASSED THROUGH TO THE CONSUMER, AND IT WON'T BE, THE AVERAGE CONSUMER WILL ACTUALLY BE PAYING LESS THAN BEFORE.

AN IMPORT FEE IS FAIR TAX POLICY AND WILL HELP TO PROMOTE ENERGY INDEPENDENCE. DOMESTIC OIL PRODUCERS PAY THE WINDFALL PROFITS TAX AS WELL AS STATE SEVERANCE TAXES. FOREIGN PRODUCERS DO NOT. WHY SHOULD OUR TAX POLICY CONTINUE TO ENCOURAGE THE CREATION OF JOBS FOR EXPLORATION AND REFINING IN OTHER NATIONS INSTEAD OF HERE AT HOME. IN MY HOME STATE OF OKLAHOMA WE HAVE LOST OVER 3,000 JOBS IN THE PAST TWO YEARS IN THE REFINING INDUSTRY ALONE.

AN IMPORT FEE CAN BE IMPLEMENTED IN A MANNER WHICH WILL MAINTAIN REGIONAL FAIRNESS AND WILL PRESERVE OUR OWN COMPETITIVENESS IN TRADE. MY PROPOSAL PROVIDES REBATES OF THE FEE FOR HOME HEATING OIL IN ORDER TO PROTECT THOSE IN NEW ENGLAND AND

THE NORTHEAST WHO DEPEND UPON THIS FUEL. IT ALSO PROVIDES A REBATE TO AMERICAN MANUFACTURERS WHO USE IMPORTED CRUDE OIL IN THE PROCESS OF MAKING PRODUCTS FOR EXPORT. THIS WOULD ENSURE THAT AMERICAN BUSINESSES LIKE THE CHEMICAL INDUSTRY WOULD NOT BE PLACED AT A COMPETITIVE DISADVANTAGE IN THE COST OF THEIR PRODUCTS FOR EXPORT TO OTHER MARKETS.

FINALLY, BESIDES PROVIDING NEEDED SECURITY FROM AN ENERGY SUPPLY PERSPECTIVE AND FROM A FINANCIAL STABILITY PERSPECTIVE, THE REVENUE RAISED BY AN IMPORT FEE CAN BE USED TO HELP REDUCE THE DEFICIT AND PROVIDE ROOM FOR BUDGET NEGOTIATIONS TO HELP RESOLVE THE CONTROVERSIAL ISSUES THAT WILL FACE US DURING THE COMING MONTHS.

MARKET CONDITIONS HAVE CHANGED SO DRASTICALLY FROM THE TIME I FIRST INTRODUCED MY BILL, THAT IT WILL BE NECESSARY TO MAKE SOME CHANGES. I BELIEVE THAT THE REFERENCE PRICE SHOULD NOW BE IN THE RANGE OF $20 TO $25. GIVEN THE RECENT VOLATILITY OF THE MARKET I DON'T BELIEVE WE SHOULD PLACE A LIMIT ON THE SIZE OF THE FEE. CONSEQUENTLY, SHOULD THE PRICE OF OIL FALL TO BELOW $10 A BARREL WE WOULD NEED A FEE LARGER THAN $5 PER BARREL.

MR. CHAIRMAN, I CAN'T BEGIN TO DESCRIBE THE ECONOMIC IMPACT THAT THE RECENT FREE FALL IN THE PRICE OF OIL HAS HAD ON MY HOME STATE. NOW IS THE TIME TO ACT. AN IMPORT FEE WILL PROTECT AGAINST FUTURE SHOCKS TO THE FINANCIAL INDUSTRY, PROMOTE ENERGY INDEPENDENCE, AND HELP REDUCE DEFICITS.

STATEMENT OF SENATOR GEORGE J. MITCHELL

I am stongly opposed to an oil import fee.

It would be hard to find a less economically or socially defensible tax proposal.

The obvious attraction of the proposal -- that it is a tax which can be hidden from the public because of declining oil prices -- is a key to all that is wrong with it.

Whenever we are asked to support a tax increase on the ground that the public won't notice it, we should be on our guard, because it is likely to be a tax increase that cannot be defended on economic, budgetary or policy grounds.

An examination of the proposed oil import fee reveals that it suffers all these defects.

Its economic effect will be to raise the price of a commodity which is so important to our economy that it would increase the rate of inflation by at least a full percentage point all by itself.

Its budgetary impact will be zero, because the President insists that a tax increase can be be used only to keep his tax proposal revenue neutral, not to reduce the deficit.

And its policy implications are clear. It would be a windfall for domestic oil producers which would exceed by three or four times the revenues collected by the government. It would be a regressive levy falling hardest on people in the lowest income brackets. It would be an artificial, government-sanctioned price prop that would burden every business and industry which uses that commodity.

The domestic imperatives driving this idea are clear, but they are not persuasive.

The oil producing states want to find a way to bail out the oil industry from the steep price decline of recent weeks. But why is this declining commodity price special? All our farm states have suffered tremendous losses because of declining commodity prices.

It is a fundamental fact of free markets that prices can move down as well as up. Why should government try to institutionalize a price whose level was artificially established in the first place?

The argument that the oil producing states are suffering a decline in income is not a reason to saddle the rest of the nation with the cost of maintaining their income.

The other pressure driving this oil import fee idea is the perceived need to preserve some corporate and individual tax breaks that now exist but which may be reduced by the tax reform bill.

But what kind of a tax reform is it that preserves special privileges for a few by imposing a regressive tax on an essential commodity? That is not reform. That is unfairness of the most blatant kind.

The poorest one-fifth of our people spend four times as much of their income on energy as the wealthiest one-fifth. To impose additional costs on these wage earners to pay for tax benefits for the top income groups in the country is simply to tax lower- and middle-income people for the benefit of the wealthy.

That would not reform our tax system. It would further deform it.

This levy also has its supporters among those who think the President's opposition to increased taxes for deficit reduction will somehow be less if the increased tax is an oil import fee rather than some other levy. That is a belief unsupported by any evidence.

The President has been as clear as he can be. He has said he wants his tax reform bill. He is insisting on the $50 to $125 billion in tax breaks he seeks to preserve. He wants to maintain his defense buildup. But he doesn't want higher taxes. He has said that any tax increase would be vetoed on arrival.

Those who see in this some sign that an oil import fee could reduce the deficit have seen something that eludes me. There is simply no indication that deficit reduction is a Presidential priority, and passage of an oil import fee will not make it one.

Oil is a commodity which has been granted special treatment by our government for many decades. Before the OPEC price gouging that ripped through our economy in the last decade, the northeast, which relies largely on imported oil, was subjected to an import quota which artificially propped up oil prices for twenty years.

During the heyday of OPEC price gouging the northeast lost jobs, income and revenues as the billions in higher prices surged to the producing regions.

Now that the effects of increased production and declining consumption are finally offering some hope of price stability, we are again faced with a claim that oil prices need artificial support.

That claim has never been persuasive to my region, where families spend 15 times as much on fuel oil as families living in the West; and where heating oil accounts for three-fourths of all energy consumed.

It is not persuasive today. If national security, energy independence, and bank safety and soundness are issues that need to be addressed, Congress can, and should, deal with these problems directly, not indirectly through an oil import fee.

And to claim that this commodity price support mechanism -- which is what this would be -- ought to be part of a tax reform effort is simply perverse.

Tax reform is more than an exercise in lowering tax rates. It should be a vehicle to reduce distortions between different kinds of economic activities, so that people operate on the basis of economic incentives, not tax incentives. What this oil import fee would do is to add a distortion, not eliminate one.

It is indefensible tax policy. And it is by no stretch of the imagination tax reform.

This nation will enjoy the substantial economic benefits that flow from a sharp decline in the price of a basic commodity; benefits that will dwarf the stimulus we could provide through the tax code. It would be folly for the U.S. Congress to attempt to reverse those benefits through an oil import fee.

TAXATION OF PETROLEUM IMPORTS

Scheduled for Hearings

before the

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

ON FEBRUARY 27-28, 1986

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled public hearings on February 27-28, 1986, on the taxation of petroleum imports.

Part I of this pamphlet[1] provides an overview of present law provisions relating to Federal tax treatment of petroleum. Part II discusses economic data relating to petroleum consumption, production and imports. Part III describes three legislative proposals for the Subcommittee hearings: S. 1507 (introduced by Senators Boren and Bentsen); S. 1997 (introduced by Senators Wallop and Bentsen); and S. 1412 (introduced by Senator Hart). Part IV discusses several issues relating to these proposals.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Taxation of Petroleum Imports* (JCS-5-86), February 26, 1986.

ERRATA for JCS-5-86
("Taxation of Petroleum Imports")
February 26, 1986

On p. 3

The third line in the first paragraph under the heading, *Petroleum tax*, should read as follows:

"tax had not already been paid, on the use *or* export *of* domestically" (emphasis on words corrected)

On p. 8

In the fifth line of the first full paragraph under Table 3, change 70 percent to "30 percent".

On p. 22

In the second line of the first paragraph under the heading, *high cost producers*, change $17 to "$16."

On p. 29

The first word of the last line of the first paragraph under the heading, **E. International Relations**, should be "net".

I. PRESENT LAW

A. Highway Trust Fund Taxes

Under present law, an excise tax is imposed on gasoline sold by a producer or importer thereof (sec. 4081), and on the sale (or use) of diesel fuel and special motor fuels (sec. 4041). The tax rate for gasoline and special motor fuels is 9 cents per gallon; diesel fuels generally are taxed at a 15-cents-per-gallon rate. Exceptions are provided for diesel and special motor fuels sold for export; used by a State or political subdivision, or by a nonprofit educational organization; used on a farm for farming purposes; and for certain other off-highway uses. Gasoline, diesel, and special motor fuels which are partially derived from alcohol (i.e., gasohol) are taxed at reduced rates.

Amounts equivalent to the revenues derived from these taxes are deposited in the Highway Trust Fund.[2] Also allocated to this Trust Fund are excise taxes on heavy trucks and trailers and on tires for heavy highway vehicles (i.e., trucks), as well as an annual use tax on certain heavy vehicles. The Highway Trust Fund taxes are each scheduled to expire after September 30, 1988.

B. Aviation Excise Taxes

A series of excise taxes are imposed on aviation, in order to fund the Airport and Airway Trust Fund. These include a 12-cents-per-gallon tax on gasoline,[3] and a 14-cents-per-gallon tax on other fuels, used in noncommercial aviation. Taxes also are imposed on commercial air passenger tickets domestic air cargo, and international passenger departures. These taxes are each scheduled to expire after December 31, 1987.

C. Inland Waterways Trust Fund Tax

A tax is imposed on diesel and other liquid fuels used for commercial cargo vessels on inland or intra-coastal waterways. The present tax rate is 10 cents per gallon. Revenues from the tax are deposited in the Inland Waterways Trust Fund.

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[2] Amounts attributable to gasoline used in noncommercial aviation are instead deposited in the Airport and Airways Trust Fund (see B., below). Amounts attributable to taxes on gasoline and special motor fuels used in motorboats are deposited in the Aquatic Resources Trust Fund ($1 million in annual revenues are reserved for the Land and Water Conservation Fund.)

[3] The 12-cent gasoline tax incorporates the 9-cent-per-gallon rate described in A., above, as well as a 3-cent aviation tax. For gasoline used in noncommercial aviation, the equivalent of the full 12 cents per gallon is deposited in the Airport and Airway Trust Fund.

D. Superfund Taxes

Prior to October 1, 1985, excise taxes were imposed on petroleum and certain chemicals to fund the Hazardous Substance Response Trust Fund ("Superfund").

Petroleum tax

A tax of 0.79 cent per barrel was imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax had not already been paid, on the use of export or domestically produced oil.

Domestic crude oil subject to tax included crude oil condensate and natural gasoline, but not other natural gas liquids. Taxable crude oil did not include oil used for extraction purposes on the premises from which it was produced, or synthetic petroleum (e.g., shale oil, liquids from coal, tar sands, biomass), or refined oil.

Petroleum products which were subject to tax upon import included crude oil, crude oil condensate, natural and refined gasoline, refined and residual oil, and any other hydrocarbon product derived from crude oil or natural gasoline which entered the United States in liquid form. The term "United States" was defined to mean the 50 States, the District of Columbia, Puerto Rico, the Northern Mariana Islands, the Trust Territory of the Pacific Islands, and any possession of the United States, as well as the Outer Continental Shelf and foreign trade zones located within the United States.

The petroleum tax expired after September 30, 1985.

Tax on feedstock chemicals

The tax on feedstock chemicals applied to the sale or use of 42 specified organic and inorganic chemicals ("feedstock chemicals") by the manufacturer, producer, or importer. These chemicals generally are hazardous substances, or may create hazardous products (or wastes) when used. The tax rates ranged from 22 cents to $4.87 per ton of the chemical concerned.

The tax on feedstock chemicals expired after September 30, 1985.

E. Crude Oil Windfall Profit Tax

An excise tax is imposed on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. Generally, the windfall profit element is the excess of the sale price over the sum of its adjusted base price and the applicable State severance tax adjustment. The windfall profit element may not exceed 90 percent of net income attributable to a barrel of crude oil.

The tax rates applicable to taxable crude oil are as follows:

Tier	Tax rate
Tier 1 oil (oil not in tier 2 or tier 3).	70 percent; 50 percent for independent producers (up to 1,000 barrels per day).
Tier 2 oil (stripper oil, Petroleum Reserve oil).	60 percent; 30 percent for independent producers (up to 1,000 barrels per day).[1]
Tier 3 oil:	
Newly discovered oil	22.5 percent for 1985-1987, 20 percent for 1988, and 15 percent for 1989 and thereafter.
Heavy oil and incremental tertiary oil	30 percent.

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[1] Independent producer stripper well oil is exempt from the tax.

Crude oil from a qualified governmental interest or a qualified charitable interest, certain front-end oil, certain Indian oil, certain Alaskan oil, certain independent producer stripper well oil, and, in the case of qualified royalty owners, up to three barrels per day of royalty production, are exempt from the tax.

The windfall profit tax is scheduled to phase out over a 33-month period, beginning after December 31, 1987, or (if later) after the cumulative revenue raised by the tax reaches $227.3 billion, but in any event no later than January 1991. Receipts from the Windfall Profit tax, net of refunds, were $6.3 billion in fiscal 1985, and are projected to decline in the Administration's fiscal 1987 budget to $4.1 billion in 1986 and $2.8 billion in 1987. (These receipts may be overstated, since projections were made before the sharp decline in the world market price of oil during the first 6 weeks of calendar year 1986.)

F. Import Fee Authority

Under the Trade Expansion Act of 1962, the President can impose oil import fees or import quotas if he finds that imports threaten the nation's security. Congress may roll back such fees by passing a joint resolution of disapproval. However, this resolution can be vetoed by the President, in which case the fees he imposed would continue in effect unless the President's veto is overridden by a two-thirds vote of both Houses of Congress. These procedures for Congressional vetoes and overrides were specified by the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223).

Under an exemption from the General Agreement on Tariffs and Trade (GATT), a tariff imposed on national security grounds is not a violation of trade agreements. Consequently, enactment of a tariff on imported petroleum for legitimate national security reasons would not result in the imposition of GATT-authorized countervailing duties or other trade penalties.

The presidential import fee authority was used, to various extents, by Presidents Nixon, Ford, and Carter. President Nixon imposed import license fees of 21 cents per barrel for crude oil and 63 cents on refined products in 1973 (this differential was intended to encourage domestic refining). President Ford imposed an additional $2 per barrel crude oil import fee in 1975, but lifted the fee early in 1976. President Carter raised the possibility of an import fee in 1977 and again in 1979, in response to which Congress adopted the veto and override provisions contained in the Crude Oil Windfall Profit Tax Act. (Both the Ford import fee and the original Carter proposal were intended to encourage action on broader energy proposals.) President Carter actually imposed a $4.62 per barrel import fee in 1980, with allocation rules that effectively converted the fee into a 10-cents-per-gallon gasoline tax. However, a resolution of disapproval was passed by the Congress, and President Carter's veto of that resolution was overridden.

G. Tariff on Imported Petroleum

Tariffs are imposed on various categories of articles that are imported into the customs territory of the United States (including the 50 states, the District of Columbia, and Puerto Rico). The tariffs generally are imposed at a uniform rate for imports from most noncommunist countries, with separate, higher rates imposed on imports from certain communist nations. Preferential treatment applies to certain imports from developing countries, specified Caribbean basin nations, and Israel. Imports from U.S. insular possessions, where the imported product is not comprised primarily of foreign materials, may be made duty-free. Tariffs are imposed pursuant to the Tariff Act of 1930 (19 U.S.C. sec. 1202 *et seq.*), and are generally subject to GATT limitations.

At present, a tariff of 0.125 cent per gallon is imposed on crude petroleum, topped crude petroleum, shale oil, and distillate and residual fuel oils derived from petroleum, with low density (under 25 degrees A.P.I.). For substances with higher densities (testing 25 degrees A.P.I. or more), the tariff is 0.25 cent per gallon.[4] (Imports from certain communist countries are subject to a 0.5-cent-per-gallon tariff, regardless of density.) A 1.25-cents-per-gallon tariff (2.5 cents, for certain communist countries) also is imposed on certain motor fuels and a 0.25-cent-per-gallon tariff (0.5 cent, for certain Communist countries) on petroleum-derived kerosene and naphtas (except motor fuels). Natural gas, together with methane, ethane, propane, butane, and mixtures thereof may be imported tariff-free. Certain Canadian petroleum also may be admitted tariff-free, subject to an exchange agreement allowing like treatment for an equivalent amount of U.S. petroleum imported into Canada.

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[4] Degrees API equals 141.5 divided by specific gravity, less 131.5.

II. PETROLEUM CONSUMPTION, PRODUCTION AND IMPORTS

Petroleum consumption

U.S. petroleum consumption peaked in 1978 at about 38 quadrillion British thermal units (Btus), and has declined by 18 percent to 31 quadrillion Btus in 1984 (see Table 1). This decline in petroleum consumption occurred concurrently with a 12 percent increase in the real output of the economy: the U.S. gross national product (GNP) increased from $3.115 trillion in 1978 to $3.492 trillion in 1984 (in 1982 dollars). The achievement of higher levels of output with smaller amounts of petroleum has been made possible by impressive improvements in energy efficiency. In 1978, 12.2 thousand Btus of petroleum were required to produce one dollar of output (measured in terms of 1982 dollars). By 1984, the petroleum requirement per dollar of output had dropped 27 percent to 8.9 thousand Btus.

Table 1.—U.S. Petroleum Consumption per Dollar of GNP, 1973–1984

[Dollar amounts measured in terms of 1982 prices]

Year	Petroleum consumption (quadrillion Btu)	Real GNP (trillion $)	Petroleum consumption per dollar of GNP (1,000 Btu/$)	Average refiner acquisition cost of crude oil ($/bbl)
1973	34.840	2.744	12.7	8.38
1974	33.455	2.729	12.3	16.80
1975	32.731	2.695	12.1	17.50
1976	35.175	2.827	12.4	17.26
1977	37.122	2.959	12.5	17.77
1978	37.965	3.115	12.2	17.26
1979	37.123	3.192	11.6	22.54
1980	34.202	3.187	10.7	32.75
1981	31.931	3.249	9.8	37.49
1982	30.232	3.166	9.5	31.87
1983	30.054	3.275	9.2	27.93
1984	31.051	3.492	8.9	26.48

Sources: Energy Information Administration, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 7, 12; Energy Information Administration, *Annual Energy Review 1984* (April 1985), p. 123; Council of Economic Advisers, *Economic Report of the President* (February 1986), p. 256.

Over the 1978–1984 period, the average refiner acquisition cost of crude oil increased by 53 percent, from $17.26 per barrel to $26.48 per barrel (in 1982 dollars), in response to which the demand for petroleum per dollar of GNP dropped by 27 percent (see Table 1). Thus, the historical experience shows that U.S. demand for petroleum is quite responsive to price.

The majority of domestic petroleum is consumed in transportation uses: almost 62 percent in 1983 (see Table 2). Motor gasoline alone accounts for 42 percent of U.S. petroleum consumption, and diesel fuel, jet fuel, and aviation gasoline together account for an additional 17 percent. Industial uses of petroleum amount to one-fourth of petroleum consumption. The remaining petroleum consumption is divided between electric utility generation (5.1 percent), residential use (4.8 percent), and commercial use (3.0 percent). Heating oil (distillate fuel) comprises 70 percent of residential petroleum use (3.3 percent of U.S. petroleum consumption), and about one-half of commercial petroleum use.

Table 2.—Petroleum Consumption by Sector, 1983

[Trillion Btu]

Petroleum product	Residential	Commercial	Industrial	Transportation	Electric utilities	Total
Distillate fuel	995.7	422.0	1,286.4	2,919.4	0	5,623.5
Kerosene	86.2	30.0	146.6	NA	0	262.8
LPG [1]	352.4	62.2	1,538.2	37.4	0	1,990.2
Motor gasoline [2]	0	103.0	113.1	12,480.8	0	12,696.9
Residual fuel	0	270.7	728.5	821.6	0	1,820.8
Asphalt and road oil	0	0	904.1	0	0	904.1
Lubricants	0	0	166.6	157.4	0	324.0
Other petroleum	0	0	2,697.4	0	0	2,697.4
Aviation gasoline	0	0	0	47.7	0	47.7
Jet fuel	0	0	0	2,140.9	0	2,140.9
Heavy oil [3]	0	0	0	0	1,439.6	1,439.6
Light oil [4]	0	0	0	0	96.2	96.2
Petroleum coke	0	0	0	0	7.9	7.9
Total	1,434.3	888.0	7,580.8	18,605.2	1,543.7	30,052.0
Percent of total	4.8	3.0	25.2	61.9	5.1	100.0

[1] Liquefied petroleum gases include ethane, ethylene, propane, propylene, butane, butylene, butane-propane mixture, ethane-propane mixture, and isobutane.

[2] Motor gasoline use in the transportation sector includes: highway and marine use; commercial sector use includes miscellaneous, public nonhighway, and unclassified only; industrial sector use includes: agricultural, construction, and industrial and commercial use.

[3] Heavy oil includes grade nos. 4, 5, and 6 residual fuel oils.

[4] Light oil includes grade no. 2 heating oil, kerosene, and jet fuel.

Source: Energy Information Administration, *State Energy Data Report: Consumption Estimates, 1960-1983* (May 1985) pp. 5-9.

Petroleum production

Domestic oil and gas exploration and development activities peaked in 1981. In that year, 681 seismic crews were employed and 3,970 rotary drilling rigs were in operation. Over 90 thousand exploratory and development wells were completed, and total depth drilled exceeded 400 million feet (see Table 3). By 1985, seismic crews had dropped 40 percent to 387, and rotary drilling rigs in operation had declined by one-half. Over the 1981-85 period, the number of wells completed fell by 20 percent, and total footage drilled declined by about 23 percent. These data indicate a substantial decline in the number of men and rigs employed in the search for oil and gas. Productivity in the oil and gas driling industry appears to have improved over the 1981–1985 period, since the decline in well completions and footage drilled (20 and 23 percent) was only half the magnitude of the decline in crews and rigs (40 and 50 percent).

Table 3.—Oil and Gas Resource Development, 1973–1985

Year	Crews engaged in seismic exploration	Rotary rigs in operation	Exploratory and development well completions [1] (1,000 wells)	Total footage drilled [1] (million feet)	Crude oil wellhead price (1982 $)
1973	250	1,194	27.69	139.42	7.86
1974	305	1,472	33.03	153.79	12.72
1975	284	1,660	38.89	181.05	12.93
1976	262	1,658	40.94	187.29	12.98
1977	308	2,001	45.86	215.70	12.73
1978	352	2,259	50.05	238.39	12.47
1979	400	2,177	51.91	243.69	16.08
1980	530	2,909	69.73	312.03	28.69
1981	681	3,970	90.13	409.13	33.80
1982	588	3,105	83.59	375.77	28.52
1983	473	2,232	74.41	313.30	25.23
1984	494	2,428	83.68	365.25	23.94
1985 [2]	387	1,980	71.84	313.90	NA

[1] Excludes service wells and stratigraphic cores.

[2] Through November 1985.

Sources: Energy Information Administration, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 64, 65; Energy Information Administration, *Annual Energy Review, 1984* (April 1985), p. 119; Council of Economic Advisers, *Economic Report of the President* (February 1986), p. 256.

Table 3 shows that drilling activity is highly correlated with the price received by domestic producers. The average wellhead price of crude oil peaked at $33.80 per barrel (1982 dollars) in 1981—the same year that drilling activity reached its highest level. By 1984, the wellhead price of crude oil had declined by 70 percent to $23.94 per barrel (1982 dollars). The decline in drilling activity over the last four years is in striking contrast to the boom in oil and gas exploration over the 1973–1981 period. During that period, well completions and footage drilled increased by approximately 200 percent, in response to a 330 percent increase in the average wellhead price of crude oil (see Table 3).

As a result of increased exploration and development activity, annual additions to gross reserves of oil and gas increased from 2.9 billion barrels in 1976 to 7.3 billion barrels in 1981 (see Table 4). Reserve additions exceeded production in 1981; consequently, proved reserves of hydrocarbons increased slightly from 69.9 billion barrels in 1980 to 70.3 billion barrels in 1981. However, since 1981, reserve additions have not quite kept pace with production, and proved reserves declined to 69 billion barrels in 1983. At current petroleum prices, it appears unlikely that future reserve additions will exceed production.

Table 4.—U.S. Production and Proved Reserves of Hydrocarbons,[1] 1976–1983

[Billion barrels]

Year	Exploration and development expenditures (billions of 1982 $)	Additions to gross reserves of hydrocarbons	Production of hydrocarbons	Proved reserves of hydrocarbons
1976	23.6	2.947	6.730	NA
1977	25.3	3.765	6.777	NA
1978	28.3	3.679	6.918	72.8
1979	41.9	5.071	6.970	70.0
1980	47.1	6.723	6.995	69.9
1981	59.3	7.303	6.954	70.3
1982	53.7	5.030	6.682	68.8
1983	NA	6.408	6.397	69.0

[1] Hydrocarbons include crude oil, natural gas liquids, and natural gas.

Sources: Energy Information Administration, *Annual Energy Review, 1984* (April 1985), pp. 77–79; Council of Economic Advisers, *Economic Report of the President* (February 1986), p. 256.

Table 4 shows that despite the doubling of exploration and development expenditures from $23.6 billion in 1976 to $53.7 billion in 1982 (in 1982 dollars), reserve additions increased only two-thirds, and production was virtually flat. These data show that the substantial increase in exploration and development activity since the 1973–74 oil price shock has not resulted in higher levels of hydrocarbon production.

Petroleum imports

Net imports of petroleum peaked in 1977 at 8.6 million barrels per day, or 46.5 percent of U.S. petroleum products supplied (see Table 5). By 1982, net imports had declined by 50 percent to 4.3 million barrels per day, or 28.1 percent of domestic petroleum products supplied. About 70 percent of the reduction in import dependence is attributable to the decline in domestic petroleum use from 18.4 million barrels per day in 1977 to 15.3 million barrels per day in 1982. The relationship between net imports and domestic demand is clearly indicated by the recent rise in import dependence from 28.1 percent in 1981 to 30.0 percent in 1984. This increase in the share of imports mirrors the rise in domestic petroleum consumption over the 1982–84 period.

Table 5.—U.S. Dependence on Net Petroleum Imports, 1973-1984

[Thousand barrels per day]

Year	Domestic field production [1]	Imports	Exports	Net imports	Petroleum products supplied	Net imports as percent of petroleum products supplied
1973	10,975	6,256	231	6,025	17,308	34.8
1974	10,498	6,112	221	5,892	16,653	35.4
1975	10,045	6,056	209	5,846	16,322	35.8
1976	9,774	7,313	223	7,090	17,461	40.6
1977	9,913	8,807	243	8,565	18,431	46.5
1978	10,328	8,363	362	8,002	18,847	42.5
1979	10,179	8,456	471	7,985	18,513	43.1
1980	10,214	6,909	544	6,365	17,056	37.3
1981	10,230	5,996	595	5,401	16,058	33.6
1982	10,252	5,113	815	4,298	15,296	28.1
1983	10,299	5,051	739	4,312	15,231	28.3
1984	10,544	5,437	722	4,715	15,726	30.0

[1] Includes crude oil, natural gas plant production, lease condensate, other hydrocarbons, and alcohol.

Source: Energy Information Administration, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 13, 37.

Most petroleum imports come from sources outside of the Organization of Petroleum Exporting Countries (OPEC): in 1984, only 35.5 percent of U.S. imports were from OPEC (see Table 6). Less than 9 percent of imports in 1984 were supplied by Arab member countries of OPEC. Mexico, Canada, and Venezuela supplied the largest shares of U.S. petroleum imports in 1984, accounting for 16.7, 15.2 and 12.2 percent of imports, respectively. Including petroleum products from Caribbean refineries, which account for an additional 9 percent of U.S. imports, almost half of petroleum imports in 1984 were from western hemisphere sources. In summary, U.S. petroleum imports are diversified among many suppliers.

Table 6.—Imports of Petroleum by Source, 1984

[Thousand barrels per day]

Country	Import volume	Percent of total imports
Algeria	186	3.7
Libya	5	0.1
Saudi Arabia	123	2.5
United Arab Emirates	48	1.0
Indonesia	306	6.1
Iran	30	0.6
Nigeria	275	5.5
Venezuela	607	12.2
Other OPEC	193	3.9
Total OPEC [1]	1,772	35.5
Total Arab OPEC [2]	434	8.7

Table 6.—Imports of Petroleum by Source, 1984—Continued

[Thousand barrels per day]

Country	Import volume	Percent of total imports
Bahamas	33	0.7
Canada	756	15.2
Mexico	831	16.7
Netherlands Antilles	36	0.7
Trinidad and Tobago	116	2.3
United Kingdom	317	6.4
Puerto Rico	30	0.6
Virgin Islands	241	4.8
Other non-OPEC	854	17.1
Total non-OPEC [3]	3,213	64.4
Total imports	4,986	100.0

[1] Includes Ecuador, Gabon, Iraq, Kuwait, and Qatar.

[2] Includes Algeria, Libya, Saudi Arabia, United Arab Emirates, Iraq, Kuwait, and Qatar.

[3] Includes petroleum imported into the United States indirectly from OPEC countries, primarily from Caribbean and West European areas, as refined petroleum products that were refined from crude oil produced in OPEC countries.

Source: Energy Information Administration, *Monthly Energy Review, October 1985*) (January 26, 1986), pp. 42–3.

To reduce vulnerability to sudden import disruptions, the United States began filling the Strategic Petroleum Reserve (SPR) in 1977. As of November 1985, the SPR contained 493 million barrels (see Table 7). At 1985 import levels, the SPR now contains sufficient reserves to replace all net imports for a period of 117 days. Under the Administration's fiscal year 1987 budget, the SPR would not be increased above 500 million barrels, about equal to its present level.

Table 7.—Strategic Petroleum Reserve, 1977–1985

[Million barrels]

Year	End of year reserve	Net imports per day	Days of net imports in reserve
1977	7	8.6	1
1978	67	8.0	8
1979	91	8.0	11
1980	108	6.4	17
1981	230	5.4	43
1982	294	4.3	68
1983	379	4.3	88
1984	451	4.7	96
1985 [1]	493	4.2	117

[1] Data on net imports is through November 1985.

Source: Energy Information Administration, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 37, 41.

Refineries

U.S. refinery output has declined 15 percent from 15.9 million barrels per day in 1978 to 13.7 million barrels per day in 1984 (see Table 8). The contraction in the refinery industry is a direct consequence of the reduction in domestic petroleum consumption over the 1978-1984 period, which occured in response to higher oil prices. Reduced demand has lowered capacity utilization in the nation's refineries, and forced many less efficient plants to shut down. The recent decline in the world market price of oil, and concurrent growth in U.S. demand, would be expected to improve the future financial situation of the domestic refinery industry.

Table 8.—U.S. Refinery Input and Output, 1973-1984

[Million barrels per day]

Year	Input	Output	Processing gain	Capacity utilization (percent)	Number of refineries[1]
1973	13.40	13.85	0.45	93.9	268
1974	13.02	13.50	0.48	86.6	273
1975	13.23	13.68	0.46	85.5	279
1976	14.20	14.68	0.48	87.8	276
1977	15.35	15.87	0.52	89.6	282
1978	15.47	15.97	0.50	87.4	296
1979	15.24	15.76	0.53	84.4	308
1980	14.02	14.62	0.60	75.4	319
1981	13.48	13.99	0.51	68.6	324
1982	12.86	13.39	0.53	69.9	301
1983	12.65	13.14	0.49	71.7	258
1984	13.14	13.70	0.56	76.1	247

[1] All operable refineries on January 1 of each year.

Source: Energy Information Administration, *Annual Revenue Energy, 1984* (April 1985) pp. 103-5.

Table 8 shows that refinery output consistently exceeds refinery input. This expansion in the volume of petroleum through the refining process is known as the "processing gain." In 1984, the average refinery gain was about 4 percent.[5]

World petroleum market

The United States consumes more petroleum products than any other country in the world, accounting for 25.6 percent of world consumption in 1982 (see Table 9A). The member nations of the Organization for Economic Cooperation and Development (OECD) together account for 58.1 percent of world petroleum consumption.

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[5] As a result, a $1 per barrel tax on crude oil is equivalent, on average, to a $0.96 per barrel tax on refined products. Consequently, a flat $1 per barrel tax on petroleum imports favors crude oil relative to refined products.

Table 9A.—World Consumption of Petroleum

[Thousand barrels per day]

Country	Consumption of petroleum, 1982	Percent of world consumption
Australia	660	1.1
Canada	1,620	2.7
France	1,940	3.2
West Germany	2,320	3.9
Italy	1,780	3.0
Japan	4,550	7.6
Spain	1,010	1.7
United Kingdom	1,590	2.7
United States	15,300	25.6
Other OECD	3,920	6.6
Total OECD	34,690	58.1
Brazil	1,080	1.8
China	1,660	2.8
Mexico	1,360	2.3
USSR	9,250	15.5
Total world	59,740	100.0

Source: Energy Information Administration, *Annual Energy Review, 1984* (April 1985), p. 225; Energy Information Agency, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 104–6.

Table 9B.—World Production of Petroleum, 1984

[Thousand of barrels per day]

Country	Production of crude oil, 1984	Percent of world production
Algeria	638	1.2
Iraq	1,209	2.2
Kuwait [1]	1,157	2.1
Libya	1,087	2.0
Qatar	394	0.7
Saudi Arabia [1]	4,663	8.6
United Arab Emirates	1,146	2.1
Arab OPEC	10,294	19.0
Indonesia	1,466	2.7
Iran	2,175	4.0
Nigeria	1,419	2.6
Venezuela	1,813	3.3
Total OPEC	17,576	32.5
Canada	1,436	2.7
Mexico	2,750	5.1
United Kingdom	2,495	4.6
United States	8,879	16.4
China	2,269	4.2
USSR	11,878	21.9
Other	6,847	12.6
Total world	54,130	100.0

[1] Includes about one-half of the production from the former Kuwait-Saudi Arabia neutral zone.

Source: Energy Information Administration, *Annual Energy Review, 1984* (April 1985), p. 225; Energy Information Agency, *Monthly Energy Review, October 1985* (January 26, 1986), pp. 104–6

Table 9B shows that the largest petroleum producers in the world are not in the Middle East: in 1984, the Soviet Union and the United States produced the largest shares of world petroleum output, which were 21.9 and 16.4 percent, respectively. Total OPEC production accounts for slightly less than one-third of world petroleum output, and Arab members of OPEC produce less than one-fifth of world output.

The price of petroleum products in the United States generally is lower than in Western Europe, the United Kingdom and Japan. For example, the average price of gasoline in the United States was $1.21 per gallon in 1984. This was one-third less than the average price of $1.89 per gallon in ten International Energy Agency (IEA) countries (see Table 10). This price differential primarily is attributable to lower gasoline excise taxes in the United States. The U.S. price advantage is considerably smaller for other petroleum products. For example, in 1984 industrial heavy oil was approximately $4 per barrel cheaper in the United States than in other IEA countries, a price advantage of 13 percent. Thus, a $5 per barrel tax would raise the price of heavy oil to U.S. industry above the price to industrial customers in other IEA countries.

Table 10.—International Petroleum Prices, Fourth Quarter 1984

Country	Diesel fuel (cents/ gallon)	Gasoline (cents/ gallon)	Heating oil (cents/ gallon)	Industrial light oil (cents/ gallon)	Industrial heavy oil ($/bbl)	Electric Generation heavy oil ($/bbl)
United States [1]	119	121	105	86	27.64	29.89
Canada	129	143	100	101	36.64	NA
France	158	220	117	112	30.53	NA
West Germany	148	181	100	88	28.33	28.52
Italy	117	260	131	114	29.62	NA
United Kingdom	162	192	98	83	31.54	NA
Sweden	132	182	110	110	40.37	37.71
Netherlands	117	204	111	NA	29.80	NA
Austria	149	153	NA	NA	NA	NA
Japan	NA	237	146	131	31.87	NA
Average	137	189	113	103	31.82	32.04

[1] U.S. price of heating oil and industrial light oil does not includes taxes.

Source: Energy Information Administration, *International Energy Review, 1980–1984*. (August 1985), pp. 38–48.

III. LEGISLATIVE PROPOSALS

A. S. 1507 (Senators Boren and Bentsen)

Explanation of Provisions

Tariff increase on imported crude oil and related products

The bill would increase the present tariffs imposed on imported crude petroleum and related refined products by adding an "applicable offset amount" to the present per barrel tariff rate. This amount would be determined by the excess of the base price of an article (as determined below) over the average world price of such article. The average world price for a particular article is to be determined by the prices of such article for the calendar quarter six months preceding the quarter in which the tariff is imposed. The Secretary of Energy is to determine, based on available information, the average world price of each article for each calendar quarter. The bill provides that the first determination of the average world price for a calendar quarter is to be for the quarter beginning on April 1, 1985 and further determinations would be made for each calendar quarter thereafter.

Determination of base price

The bill provides that for crude petroleum, the base price is $30 per barrel. The applicable offset amount for crude petroleum would be limited to a maximum of $5 per barrel although it could be a lesser amount if the average world price exceeded $25 per barrel. For motor fuel; kerosene derived from petroleum or shale oil; naphthas derived from petroleum, shale oil, or natural gas; and other mixtures of hydrocarbons in liquid form; the base price is $35 per barrel. The limit for the applicable offset amount for each of these articles is $10 per barrel. In the event the average world price of a particular article equals or exceeds the base price for such article, the present per barrel rate contained in the Tariff Schedules of the United States would continue to be imposed.

Procedures and administration

The bill provides that the revenues generated from the increased tariff are to be allocated into a new account in the general fund of the Treasury known as the Petroleum Tariff Account. To the extent the account is not reduced by any refunds (as discussed below), the balance in the account is to be used to reduce the deficit in the Federal budget. The increased tariff is to be imposed and collected in the same manner as the present tariff.

The Secretary of Engery is directed to publish the average world price of each article for each quarter in the *Federal Register* by no later than 60 days following the close of each calendar quarter. The Secretary of the Treasury is directed to publish the applicable offset amount for each article for each quarter in the *Federal Register* by no later than 15 days before the beginning of each calendar quarter.

Exceptions to the tariff

The bill provides that the revenues generated by the tariff may be refunded from the Petroleum Tariff Account if (1) any article is shown to be used as heating fuel, or in the production of heating fuel, or (2) it is shown that the article is necessary and inherent to the manufacturing process of exports. The bill does not specify how refunds are to be determined in certain situations (e.g., when the average world price of an article fluctuates between the quarter in which the article is imported and the quarter in which the article is used).

Effective Date

The bill does not provide any effective date for the increased tariff. Because the Secretary of Energy is directed by the bill to begin determining the average world price for each article for the calendar quarter beginning April 1, 1985, the earliest date the bill could be effective is for the quarter beginning January 1, 1986.

B. S. 1997 (Senators Wallop and Bentsen)

Explanation of Provisions

Excise tax on imported crude oil and petroleum products

This bill would impose an excise tax on crude oil or refined petroleum products that are imported into the United States, in the amount described below. The tax would be imposed, on the first sale of the crude oil or refined product within the United States. If the crude oil or refined product is used before tax otherwise has been imposed, then the tax would be imposed on that use. The tax would be paid by the seller of the taxable product (in the case of use, by the user of the product).

All non-domestic crude oil (as defined for purposes of the crude oil windfall profit tax) would be subject to the tax. Refined petroleum products subject to the tax would include imported refined oil, fuels, and chemical feedstocks which are refined or derived from oil, but would not include process fuels, heating oil for household use, residual fuel oil, and topped crude oil imported for further refining. Liquid natural gas imports would not be subject to the tax.

Amount of tax

For crude oil imports, the amount of tax per barrel [6] would equal the excess (but not below 50 cents) [7] of (1) the reference price of $22 per barrel, over (2) the world price, determined by taking the average of the per barrel prices for Rotterdam brent crude, Saudi light, and North Sea forties crude oil, as of the end of the preceding calendar quarter. (This determination would be made by the Secretary of the Treasury, after consulting with the Secretary of Energy.)

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[6] A barrel is defined as 42 United States gallons.

[7] It is the staff's understanding that the intent of this provision is that no tax would be imposed if the reference price exceeded the average price by less than 50 cents (e.g., if the average price were $21.50 or more in 1986).

For imports of refined petroleum products, the tax rate would be determined by adding (1) the amount of tax per barrel of crude oil, as determined above, and (2) an "environmental outlay adjustment" of $3 per barrel. This rate then would be multiplied by the barrel-of-oil equivalent of the refined product. (One barrel-of-oil equivalent equals 5.8 million Btu's.) The environmental outlay adjustment appears to apply to imports of refined products even when the world price of oil exceeds the reference price.

Both the $22 reference price and the $3 environmental outlay adjustment would be indexed for changes in per capita gross national product (GNP), beginning in calendar year 1988. This would be accomplished by multiplying each amount by the percentage (if any) by which the average per capita GNP for the 36-month period ending the previous June 30 exceeds the average per capita GNP for the 36-month period ending June 30, 1985. The amounts so determined would be rounded to the next highest dollar. The Treasury Department would be required to publish the adjusted amounts not later than December 15, 1987, and in each succeeding calendar year.

Exceptions to tax

As indicated above, the tax would not apply to process fuels, liquid natural gas, heating oil for household use, residual fuel oil, and topped crude oil imported for further refining.[8]

An exception to the tax also would be provided for crude oil or refined petroleum products that are sold for export, or for resale to a second purchaser for export. The tax would be reimposed on such transactions unless, within 6 months after the sale, the seller receives proof that the crude oil or refined product actually has been exported. For purposes of this exception, the term "export" includes shipment to a United States possession.

Procedure and administration

Procedures, tax returns, and penalties with respect to the tax would be equivalent to those applicable to the crude oil windfall profit tax, except as provided by Treasury regulations where such treatment would be inappropriate.[9] Persons subject to the tax also would be required to register with the Treasury Department before actually incurring liability for the tax.

Deductibility against income tax

The tax imposed by the bill would be fully deductible against Federal income taxes.

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[8] The staff understands that the sponsors of the bill are considering narrowing the exemptions from tax.

[9] Except as otherwise provided in regulations, the windfall profit tax is required to be withheld by the first purchaser of domestic crude oil from the price paid for the oil; if withholding is not required, the tax is paid by the seller. The purchaser and operator also may elect to have the operator assume the purchaser's responsibilities under certain cases. Returns are filed on a quarterly basis, with semimonthly deposits being required for major refiners and retailers and monthly deposits (not later than 45 days after the close of the month) for most other purchasers.

Effective Date

The provisions of the bill would apply with respect to sales of imported crude oil and refined petroleum products in calendar quarters beginning more than 30 days after the date of enactment.[10]

C. S. 1412 (Senator Hart)

Explanation of Provisions

$10 per barrel additional tariff

This bill would impose an additional $10 per barrel tariff on imports of crude petroleum and refined products that are subject to tariffs under present law.[11] The additional tariff would not apply to natural gas imports, or to any other import which presently may be made tariff-free. Tariffs would be imposed (when applicable) on imports into the customs territory of the United States (including the 50 states, the District of Columbia, and Puerto Rico.)

Application of revenues

Under the bill, the Secretary of Health and Human Services and the Secretary of Energy would determine the monetary effect of the additional tariff on lower-income individuals and families adversely affected by increased energy costs. An equivalent amount of revenues from the tariff would be used to increase funding for Federal programs under which financial assistance (including loans and loan guarantees) is provided to such individuals and families. Remaining revenues would be applied to reduce social security taxes. This reduction would be allocated among States in proportion to the monetary effect of the increased tariff on the residents of that State, again as determined by the Secretary of Health and Human Services and the Secretary of Energy.[12] The reduction itself would be implemented by the Secretary of the Treasury, in fiscal years beginning after the date of enactment.

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[10] The bill does not specify whether use of crude oil sold before the effective date would be subject to the tax (e.g., by means of a floor stocks tax).

[11] *See*, Section I.G., above, for present law tariff provisions.

[12] This would appear to require the imposition of different social security tax rates in various states.

IV. ISSUES

A. Energy Policy

In general

A tax on the sale or use of imported petroleum (such as provided by S. 1997) is economically equivalent to an increase in petroleum tariff rates (such as provided by S. 1507). Both would raise the domestic price of petroleum above the world market price by the amount of the tax or tariff.[13] This would influence both the domestic demand and supply for petroleum.

Domestic consumers confronted with higher petroleum prices over time will reduce petroleum consumption. Demand reduction occurs as consumers shift to alternative fuels, improve energy efficiency, and curtail consumption of goods and services produced from petroleum.

Domestic producers would receive an increased price for existing production. In addition, some domestic petroleum and synthetic fuels which are unprofitable to develop at world market prices may be produced at a profit as a result of tariff protection. This would tend to increase domestic petroleum production.

The supply and demand effects of an oil import tax both tend to reduce the share of petroleum imports in the domestic market. With higher domestic production and lower domestic consumption, there would be a reduction in imports into the U.S. market.

Energy security

The sharp increases in the world price of oil in 1973–74 and 1979–80 have raised concerns about the vulnerability of the U.S. economy to world oil market shocks. Although net petroleum imports have declined from over 46 percent to less than 30 percent of U.S. petroleum supply, concern remains that the U.S. is overly dependent on foreign petroleum. Some support a tax or increased tariffs on imported petroleum to reduce import dependence.

Others argue that reducing the share of imports in the U.S. petroleum market will not necessarily reduce U.S. vulnerability to oil price shocks. Since oil is traded in a world market, a shortage which pushes up the world price immediately will increase the domestic price. Price controls, such as existed before 1980, can be used to dampen price shocks; however, shortages may arise. As an alternative, the Strategic Petroleum Reserve (SPR), which now contains a 117-day supply of imports, may be used to drive down the price of petroleum in the event of a world shortage.

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[13] At a sufficiently high tariff rate, imports would be eliminated and the domestic price of petroleum might rise by less than the full amount of the tariff.

Since petroleum reserves are finite, policies which encourage substitution of domestic for imported petroleum may reduce import dependence in the near term, while increasing long-run dependence on foreign oil.

High cost producers

The spot market price of West Texas Intermediate has declined by approximately 40 percent, from $26 to $17 per barrel, during the first 6 weeks of 1986. Some attribute this precipitous decline in the price of oil to an intentional flooding of the world market by Saudi Arabia and other OPEC members. It is argued that OPEC intends to drive high cost producers, such as tertiary recovery and heavy oil producers, out of the market. This might allow OPEC to raise prices sharply in the future.

An oil import tax could be used to protect high cost domestic petroleum producers from the decline in world oil prices. However, this approach would be expensive for consumers since both high and low cost producers would be subsidized by an import tax. A less costly alternative would be to target financial assistance to high cost producers, although this would be complex to administer.

Government intervention in the oil market may be unnecessary if the market anticipates a sharp increase in the world market price of oil. If this scenario is anticipated by high cost producers, then they will retain production capability until prices rise, or their reserves may be purchased by investors who anticipate a future price increase.

Price volatility

Both S. 1507 and S. 1997 would impose a "floating tax" on imported petroleum. The amount of the tax (tariff) depends on the excess of a specified base price over the world market price of petroleum. The floating tax boosts the domestic price of petroleum up to the base price when the world market price drops below this base price amount (under S. 1507 the floating tax is limited to $5 per barrel for crude oil and $10 per barrel for petroleum products). The floating tax concept is advocated as a means of stabilizing the domestic price of oil.

Rapid swings in the price of oil may impose real burdens on the economy. However, the floating tax proposals do not reduce domestic price volatility when the world market price is above the base price. Under S. 1507, the volatility of crude oil prices also is not reduced when the world market price falls below $25 per barrel (due to the $5 per barrel tax ceiling). Under certain circumstances, these proposals actually could magnify the volatility of the domestic price of oil because of lags in measuring the world market price. Under S. 1507, the base price of crude oil is $30 per barrel, and the world market price of oil is determined with a 6-month lag. If the world market price of oil increases from $25 per barrel, 6 months before the floating tax takes effect, to $40 per barrel, on the effective date, a $5-per-barrel tax would be imposed (the excess of the $30 base price over the $25 world market price 6 months earlier). Thus, the domestic price of crude oil would increase $20 per barrel (from $25 to $45 per barrel) over the 6-month period, even though the increase in the world market price is only $15 per barrel (from $25 to $40 per barrel).

B. Industry Impacts

Industrial use of petroleum products

Industrial customers accounted for over 25 percent of petroleum in the United States in 1984. A petroleum import tax would raise the price of petroleum products to domestic consumers, and increase production costs for industries that use petroleum products as fuels or feedstocks. Industries that use natural gas also would confront higher production costs to the extent that the price of natural gas rises in response to a tax on petroleum. In addition, manufacturers that use materials (e.g., plastics) and services (e.g., electricity) produced from petroleum would experience increased production costs as a result of an oil import tax. These cost increases are part of the way in which a tax on imported oil encourages conservation.

An oil import tax may have adverse affects on energy intensive manufacturers that compete with foreign producers in the United States or in foreign markets. For example, under an oil import tax, foreign petrochemical manufacturers would have an advantage over domestic producers since foreign producers would not be subject to tax on their petroleum feedstocks. As a result, a petroleum import tax creates an advanatge for imported over domestically manufactured petrochemicals. Similarly, U.S. exports of petrochemicals would be disadvantaged relative to foreign-produced petrochemicals.

The effect of a $5 per barrel petroleum import tax on manufacturing can be estimated from the energy intensity of domestic industries. Table 11 shows the quantity of petroleum products directly consumed in the major industry groups relative to the value of shipments. The industries with the most intensive use of petroleum products are: paper; stone, clay, and glass; chemicals; and primary metals. The tax burden imposed by a $5 per barrel petroleum tax as a percent of the value of shipments is: 0.4 percent in paper; 0.1 percent in stone, clay, and glass; 0.1 percent in chemicals; and 0.08 percent in primary metals. These estimates understate the total burden since indirect petroleum consumption (e.g., electricity), and the effect of a petroleum tax on competing fuels (e.g., natural gas) is not taken into account.

Table 11.—Industrial Use of Petroleum Products, 1980

Industry group	Petroleum products used (Trillion Btu)	Value of shipments (Billion dollars)	Petroleum use per dollar of shipments (Btu/$)	Import tax as a percent of shipments (%)
Food and kindred products	108.3	256.2	422.9	0.03
Tobacco products	2.8	12.2	232.0	0.02
Textile mill products	42.3	47.3	896.0	0.07

Table 11.—Industrial Use of Petroleum Products, 1980—Continued

Industry group	Petroleum products used (Trillion Btu)	Value of shipments (Billion dollars)	Petroleum use per dollar of shipments (Btu/$)	Import tax as a percent of shipments (%)
Apparel and textile products	3.7	45.8	81.5	0.01
Lumber and wood products	29.9	47.1	634.3	0.05
Furniture and fixtures	4.8	22.3	216.5	0.02
Paper and allied products	366.7	72.8	5,037.0	0.40
Printing and publishing	6.0	69.5	86.2	0.01
Chemical and allied products	193.7	162.5	1,192.1	0.10
Petroleum and coal products	59.7	198.7	300.5	0.02
Rubber and plastic products	28.3	47.3	597.4	0.05
Leather and leather products	4.5	9.8	462.3	0.04
Stone, clay and glass	56.3	46.1	1,220.6	0.10
Primary metal industries	136.6	133.9	1,020.0	0.08
Fabricated metal products	26.0	116.2	223.5	0.02
Machinery, except electrical	23.4	180.7	129.6	0.01
Electric equipment	18.3	128.6	142.4	0.01
Transportation equipment	35.4	186.5	189.9	0.02
Instruments, related products	8.4	44.1	190.8	0.02
Miscellaneous manufacturing	5.4	25.0	217.8	0.02
Total, all industries	1,160.7	1,852.7	626.5	0.05

Source: U.S. Bureau of the Census, *Census of Manufacturing*, 1982.

If it is desired to reduce the impact of an oil import tax on U.S. manufacturers, a refund (or income tax credit) for industrial use of petroleum and petroleum products could be considered. However, this would be difficult for a number of reasons.

Although the impact of higher petroleum prices affects all users of oil products, only 32 percent of petroleum used in the United States would be taxed under an import tax. A refund for all industrial use of petroleum, which accounts for 25 percent of petroleum use, potentially would forfeit 78 percent (25 divided by 32) of the tax collected on imports.

A refund of tax for industrial use of petroleum might be limited to petroleum products that are imported or refined from imported crude oil, as is the case in S. 1507. However, tracing the use of imported petroleum would be complicated because oil is fungible. Also, no relief would be provided for industrial use of petroleum products refined from domestic crude. As a result, there would be an incentive not to refine domestic crude for industrial purposes. Furthermore, industrial customers actually might pay a premium for products refined from foreign oil in order to be eligible for a tax refund.

A refund of tax for industrial use of petroleum would not compensate for higher electricity costs, and coal and natural gas prices that would result from a petroleum import tax.

Increasing the Federal excise tax on gasoline and diesel fuels has been suggested as a alternative to a petroleum import tax to reduce adverse competitive impacts.

Refinery impact

Both S. 1507 and S. 1997 would impose a higher rate of tax on imports of refined petroleum products than on imports of crude oil. The tax differential for refined products provides some protection for domestic refiners. This would allow domestic refiners to increase profit margins, and encourages expansion of domestic refinery output. Increased U.S. refining activity would reduce imports of refined petroleum products relative to crude oil. (Refined products accounted for 36 percent of petroleum imports in 1985).

The benefit that domestic refineries might obtain from a differential tax on imported refined products would be reduced to the extent that exemptions are provided for certain petroleum products. S. 1507 exempts heating fuel and products used to manufacture exports; S. 1997 exempts process fuels and residual fuel oil. Since the tax on imported crude oil raises production costs of domestic refineries, exemptions for imported refined products favor foreign over domestic refineries. The net effect of these legislative proposals on domestic refineries depends on whether the higher profit margin on taxed petroleum products offsets the lower margin on exempt products.

A tax on imported crude oil would increase refiner acquisition costs above the world market price, which would reduce the export competitiveness of U.S. refiners. Thus, a tax on imported petroleum would reduce profits from exports of refined products unless domestic refiners are compensated for higher petroleum acquisition costs.

Some argue that a differential tariff on refined petroleum products is justified because environmental regulations impose higher compliance costs on U.S. refiners than on many of their foreign competitors. Others contend that the logic of this argument implies that the tariff on refined products should vary according to the stringency of environmental regulations in the country where imported refined products are produced. Also, many other domestic industries confront high environmental compliance costs and do not receive tariff protection. Some industries with high environmental costs, such as chemicals and pulp and paper, could become less competitive as a result of a tax on imported petroleum.

Banking

The decline in the world market price of oil has reduced the value of oil industry assets and the value of land located in oil producing regions of the countries. Loans based on the value of oil industry assets are threatened by the recent decline in petroleum prices. As a result, banks with a large portfolio of energy-related loans may be confronted with reduced income and possible insolvency. One argument for a tax on imported oil is that it would reduce the failure rate of banks with significant domestic energy loans. This would reduce potential Federal government outlays to the extent that these lending institutions are Federally insured.

Others argue that present law addresses the problem of bank failures at a lower cost to taxpayers than would be the case under an oil import tax. Under persent law, Federal expenditures are targeted to financially troubled lending institutions. An oil import tax would benefit all lending institutions with domestic energy loans, regardless of risk of loss or insolvency, and the cost would in large part be borne by energy consumers.

A number of U.S. banks have made large loans to Mexico, Venezuela, and other oil exporting countries. A tax on imported petroleum could reduce the ability of oil exporting countries to service their debts to U.S. banks. Consequently, a petroleum import tax could harm some banks with international loans to oil exporting countries while helping other banks with domestic energy loans. Thus, a tax on imported petroleum may not be beneficial to the U.S. banking industry as a whole.

C. Income Distribution of Tax Burden

A tax on imported petroleum may be passed through to individuals in the form of (1) higher prices for products whose manufacture requires petroleum, (2) lower wages paid by petroleum using firms, (3) reduced dividends and distributions made by petroleum using firms, and (4) higher wage, dividend, and royalty income from petroleum production and related activities. Since petroleum is used in virtually all sectors of the economy, it is difficult if not impossible to trace the full effect of a tax on imported petroleum on prices. A tax on imported petroleum may result in higher prices of petroleum substitutes such as natural gas. These price increases also may redistribute domestic income.

One way to analyze the distributional impact of a petroleum tax is to limit consideration to direct household consumption of refined petroleum products. Table 12 shows that low-income households spend a much larger portion of household income on refined products than high-income households. Households with income below $5,000 in 1980–81 spent 52.8 percent of household income on refined products, while households with income over $50,000 devoted only 3.1 percent of income to refined products. As a result of this consumption pattern, the burden of a $5 per barrel tax on petroleum would fall relatively more heavily on lower income households. Such a tax would amount to a 5.0-percent tax on the income of households in the below-$5,000 income class, compared to a 0.3-percent tax on the income of households in the above-$50,000 income class.[14]

Table 12.—Income Distribution of Petroleum Consumption, 1980–1981

Income class (dollars)	Household petroleum [1] expenditures as a percent of income (percent)	Household petroleum consumption per dollar of income (Btu/dollar)	Import tax [2] as percent of income (percent)
0–5,000	52.8	53,001	5.0
5–10,000	11.5	11,454	1.1
10–20,000	8.8	8,720	0.8
20–30,000	6.9	6,802	0.6
30–40,000	5.8	5,742	0.5
40–50,000	4.8	4,777	0.5
50,000+	3.1	3,034	0.3
Total	7.9	7,840	0.7

[1] Includes home heating oil, liquefied petroleum gas, gasoline, diesel fuel, kerosene, and motor oil.

[2] Assumes $5 per barrel tax on imported crude oil and refined products with no exemptions.

Source: U.S. Bureau of the Census, *Consumer Expenditure Survey.*

D. Regional Impacts

A tax on imported petroleum would have varying effects on regional income as a result of differences in petroleum production and consumption in different parts of the country. Regions that derive most of their energy from coal and nuclear power would benefit relative to regions that are dependent on petroleum. Petroleum producing areas of the country generally would benefit relative to areas without petroleum reserves. However, to the extent that shareholders of petroleum companies reside outside of producing regions, some of the benefits of higher oil prices would accrue in net energy consuming regions of the country. The adverse effect of an oil import tax on manufacturing income would be felt by the owners and employees of petroleum intensive companies in every region of the country.

One way to assess the regional impact of an oil import tax is to compare the consumption of petroleum products in different regions of the country.[15] Table 13 shows the regional distribution of petroleum product consumption in 1983. On average, 11 thousand Btus of petroleum were consumed per dollar of personal income in the United States in 1983. In the west south central states, petroleum consumption was 20.2 thousand Btus per dollar of personal income, almost twice the national average. These data suggest that the west south central states would be adversely affected by a petroleum import tax compared to the middle Atlantic and north central states where petroleum consumption is about 20 percent less than the national average.

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[14] This analysis considers only direct petroleum consumption by households and assumes that a petroleum tax is passed through to consumers in the form of higher prices for refined products.

[15] This analysis assumes implicitly that the burden of a petroleum tax on an industrial user falls in the region of the country where the use occurs. Also, this analysis does not take into account the effect of higher petroleum prices on the income from petroleum producing and related activities, nor the effect on prices of competing fuels such as natural gas. For a discussion of issues involved in modeling regional effects of energy price changes see, Joeseph P. Kalt and Robert A. Leone, "A Model of Regional Income Accrual Under Energy Price Decontrol," Harvard Institute for Economic Research, Discussion Paper 1041 (February 1984).

Table 13.—Regional Distribution of Petroleum Consumption,[1] 1983

[Thousand Btu's per dollar of personal income] [2]

Region [3]	Residential	Transportation	Industrial and commercial	Total
New England	1.6	4.9	4.4	10.9
Middle Atlantic	0.9	4.7	3.2	8.8
Eastern North Central	0.4	5.6	2.7	8.7
Western North Central	0.7	7.3	3.5	11.4
South Atlantic	0.5	7.5	2.8	10.7
Eastern South Central	0.3	9.1	3.2	12.6
Western South Central	0.2	9.9	10.2	20.2
Mountain	0.3	8.3	3.0	11.6
Pacific Coast	0.1	7.1	2.1	9.3
U.S. average	0.5	6.8	3.7	11.0

[1] Includes road oil, aviation gas, distillate fuel, kerosene, liquified petroleum gas, lubricants, motor gasoline, residual fuel, and other petroleum products.

[2] Personal income is defined as income from all sources before tax, excluding military employees stationed abroad.

[3] New England includes CT, ME, MA, NH, RI, VT; Middle Atlantic includes NJ, NY, PA; Eastern North Central includes IL, IN, MI, OH, WI; Western North Central includes IA, KS, MN, MO, NE, ND, SD; South Atlantic includes DE, FL, GA, MD, DC, NC, SC, VA, WV; Eastern South Central includes AL, KY, MS, TN; Western South Central includes AR, LA, OK, TX: Mountain includes AZ, CO, ID, MT, NV, NM, UT, WY; and Pacific Coast includes CA, OR, WA.

Source: U.S. Dept. of Energy, Energy Information Agency, *State Energy Data Survey*, 1983.

Table 13 shows that the high rate of petroleum consumption in the southwest is due to transportation and industrial use of petroleum, rather than residential use. Residential petroleum consumption is less than half the national average in the west south central and pacific coast states, and more than three times the national average in New England. This is due primarily to the greater consumption of home heating oil in the northeastern region of the United States. Consequently, an oil import tax would more adversely affect residential petroleum consumers in the northeastern than in the southwestern States.

In contrast to residential petroleum use, industrial and commercial use of petroleum is three times the national average in the southwestern states. Transportation use of petroleum, primarily gasoline, is almost 50 percent above the national average in the southwest, compared to 30 percent below average in New England and the middle Atlantic States.

While the oil-producing States would benefit substantially from higher oil prices that would result from an import tax, the data in Table 13 show that part of this benefit is likely to be offset because these States spend a much higher proportion of personal income on petroleum products. To determine the net effect of a petroleum import tax on any region of the country requires tracing the increase in oil-related income to the ultimate recipients of this income, and tracing the increase in the price of products derived from petroleum to the consumers of these products.

E. International Relations

The effect of a tax on an increased tariff on petroleum would be to raise the domestic price of petroleum relative to the world market price. This relative price shift occurs either because the domestic price of petroleum increases, or because they world market price falls. In the former case, the tax merely distributes income from domestic consumers to domestic producers and the government. In the latter case, the tariff has no effect in the United States; instead, the effect of the tariff is to transfer wealth from countries that are net petroleum exporters to countries that are not importers, such as the United States.

An importing country may be able to shift the burden of a product tariff to exporting countries in situations where it consumes a large portion of world production, and its demand for the product is relatively sensitive to price changes. Some argue that a U.S. tax on imported oil is desirable because some of the tax would in effect be paid by exporting countries in the form of a reduced world market price of oil. Importers such as Japan and Europe would benefit from a decline in the world price of oil resulting from a U.S. tariff on oil imports.

To the extent that a U.S. tariff or import tax lowers the world market price of petroleum, countries that are net petroleum exporters would experience a decline in export income. This could reduce the ability of countries such as Mexico and Venezuela to service their debts to U.S. banks. In order not to jeopardize debt repayment agreements with Mexico and Venezuela, some have suggested that these countries should be exempt from a U.S. tax on imported petroleum. Others argue that only Mexico should be exempted because Venezuela is a member of OPEC. However, under a treaty of friendship, commerce, and navigation (FCN), the United States is obliged to tax Venezuelan products at the most favorable rate applicable to other nations. Thus, an exemption for Mexico might require a similar exemption for Venezuela.

Exemption from a petroleum import tax also has been proposed for Caribbean countries that export refined products to the United States (principally the Virgin Islands, Puerto Rico, the Netherlands Antilles, the Bahamas, Trinidad, and Tobago). Such an exemption might be desirable to avoid overriding the zero rate of tariff extended to most Caribbean countries under the Administration's Caribbean Basin Initiative.

Some argue that Canada also should be exempted as a reward for recent concessions granted on energy sales to the United States. However, under the most favored nation provisions of the General Agreement on Tariffs and Trade (GATT), special tariff treatment provided to one signatory country (such as Canada) must be extended to all GATT signatories, unless a waiver is approved by the GATT Council. (The trade benefits extended by the Caribbean Basin Initiative are permitted by GATT as a result of such a waiver.) Thus, an exemption for Canada may necessitate exemptions for the United Kingdom as well as a number of OPEC countries to which GATT rules apply, namely: Indonesia, Nigeria, Algeria, the United Arab Emirates, Gabon, Kuwait, and Qatar.

Mexico, Venezuela, the Caribbean, and GATT signatory countries supplied 90 percent of U.S. petroleum imports in 1985. Consequently, exempting these countries from a petroleum import tax would reduce tax revenues by 90 percent. More revenue might be lost as a result of exempt countries shifting oil exports to the United States, or diversion of oil from non-GATT producers (such as Saudi Arabia) through GATT producers (such as Algeria). While rules could be adopted to deny exemption to diverted oil, it may not be possible to make these rules work effectively.

F. Revenue Effect

A $5-per-barrel tax on imported crude oil and petroleum products, with no exemptions, beginning in fiscal year 1987 (October 1, 1986), is estimated to increase net tax receipts by $7.4 billion in 1987. Over 5 fiscal years, such a tax is estimated to increase net tax revenues by $37.8 billion. These estimates take into account increased windfall profit tax collections, reduced gasoline excise tax collections, and lower income tax receipts as a result of the deductibility of the tax on business petroleum expenditures.

Exemptions from a petroleum import tax could reduce revenues significantly. For example, Mexico and Canada accounted for 32 percent of petroleum imports in the first 11 months of 1985. Consequently, an exemption for imports from these two countries would reduce gross revenues from a petroleum import tax by about one-third. Caribbean countries supplied 9.1 percent of U.S. imports in 1985 (through November), and Venezuela supplied 12.2 percent. If exemptions also were provided to Venezuela and the Caribbean countries, the reduction in gross revenues from a petroleum import tax would rise to over one-half.

Exemptions for home heating oil and industrial use of petroleum also may be expensive. About 3 percent of petroleum is used for residential heating oil, and an additional 26 percent is used by industry.[16] Thus, industrial use of petroleum products and residential use of heating oil together account for 29 percent of U.S. petroleum consumption. By contrast, gross imports accounted for only 32 percent of U.S. petroleum consumption in 1985. Thus, 90 percent of gross revenues from an import fee might be lost if rebates were provided for home heating oil and industrial petroleum use. Refunds could be limited only to home heating oil and industrial use of products refined from imported oil (as in S. 1507). However, to maximize refunds it is likely that imported oil would be used primarily to refine products qualifying for a rebate.

Both S. 1507 and S. 1997 would impose a floating rate of tax on imported petroleum, depending on the world price of oil, rather than a specific dollar amount of tax per barrel. Thus, the amount of revenue raised by these bills depends on the future price of oil in the world market. Given the tremendous uncertainty about the future course of world oil prices, any revenue estimate of these legislative proposals must be viewed as subject to a large margin of error. If Congress wishes to use a petroleum import tax to achieve a specific revenue target, the rate of tax would need to be set equal to a fixed amount per barrel to avoid revenue fluctuations due to unanticipated swings in the world price of petroleum.

G. Macroeconomic Effect

A tax on imported petroleum can be expected to increase the domestic price of petroleum products and competing fuels, such as natural gas. At least initially, this would increase the overall price level. With higher prices, consumer demand for money increases. Unless the Federal Reserve System accommodates the increased demand for money by increasing the money supply, the result would be somewhat higher interest rates. Higher interest rates may adversely effect investment in plant and equipment and consumer durables, and this may reduce economic growth. During the oil price shocks of 1973–74 and 1979–80, inflation and interest rates both increased sharply, and real GNP declined.[17]

Data Resources, Inc. estimates that a $5 per barrel decline in the price of oil will add 0.6 percentage points to real GNP growth and will cut the consumer price index inflation rate by a full percentage point in the first year.[18] A $5 per barrel petroleum import tax would be expected to offset much of the anticipated macroeconomic benefits from a fall in world oil prices.

To the extent that petroleum imports are reduced by an oil import tax, the value of the dollar would be expected to increase relative to other currencies. This would tend to put downward pressure on U.S. prices which would offset, to some degree, the increase in the price level caused by higher energy prices. However, the merchandise trade balance may not improve, even if petroleum imports decline, because the higher value of the dollar may cause imports of other products to increase.

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[16] Distillate oil consumed in the residential sector amounted to 3.3 percent of total U.S. petroleum consumption in 1983. More recent data indicate that industrial use of petroleum products accounted for 25.8 percent of U.S. consumption in 1984.

[17] Real GNP declined by 0.5 percent in 1974 and by 0.2 in 1980. Inflation, as measured by the GNP implicit price deflator, increased from 6.5 percent in 1973 to 9.1 percent in 1974, and from 7.3 percent in 1978 to 8.9 percent in 1979. Three-month Treasury Bill rates increased from 7.0 to 7.8 percent over the 1973–74 period, and from 10.0 to 11.5 percent over the 1979–80 period.

[18] Data Resources, Inc., *Forecast Summary*, p. 5.

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Senator **Wallop**. Good morning.

I want to begin by thanking in advance the many expert witnesses who will have taken time to appear before the subcommittee and participate in what I expect will be a lively discussion on the merits as well as potential problems of an oil import fee.

Let me begin this hearing by making one point perfectly clear. It is my strong belief that energy taxation, discussed within the confines of tax reform and deficit reduction, is not a rational approach. An energy tax in either of these forms will fail to achieve real deficit reduction for genuine tax reform and will neglect energy policy.

As I have repeatedly said since Senator Bentsen and I introduced S. 1997, I am not yet convinced that an energy excise tax is the only or even the most appropriate course to take. And it is the purpose of these hearings to determine just that.

If there is merit to an oil import fee of any description, there is only one choice in my mind, and it is not the flat tax advocated by some of my colleagues. Rather, it is the floating fee approach taken in S. 1997 that Senator Bentsen and I have designed. Though there would be some revenue effect, this floating tax cannot be dubbed a revenue raiser because it would never provide Treasury with a constant predetermined source of revenue. And, furthermore, the tax would automatically phase out when the world price of oil hits the bill's survival price. Most importantly, it would provide a source of stability for our domestic energy producers, including coal, renewals and conservation.

It is my hope that the arguments expressed today and tomorrow will receive careful consideration from my colleagues, and that the Senate will not choose an energy tax as some simple narcotic to relieve the immediate and nagging pains of tax reform or deficit reduction.

It would only serve as temporary relief with serious long-lasting ripple effects from which future generations would surely suffer.

In calling for these hearings, my purpose and that of Senator Bentsen was and is to identify the energy policy arguments surrounding any potential justification and consequence of implementing an oil import fee. Right now, these hearings are ironically timely in light of the precipitous drop in world oil prices, which has brought new opportunities, new problems and even mixed blessings for our Nation and for my home State of Wyoming.

If I sit quietly in my office, it is possible to hear all the way from Wyoming the joyful whoops and hollers from ranchers now expecting price relief in one of their biggest fixed cost. And my State, which produces and certainly consumes energy, is already optimistic that potentially low gasoline prices this summer will boost our sagging economy by bringing more visitors to Yellowstone and Grand Teton National Parks.

But on the other hand, Wyoming, like every other energy exporting State, has suffered dramatically from falling oil prices. A Casper oil man recently pointed out to me that as a general rule of thumb that for every $1 decrease in the price of crude, my State at all levels suffers and income loss of $15 million per year in ad valorem taxes, severance taxes, State and Federal royalties.

The other boot drops as a result of less money paid to drill new wells, which translates into leaner revenues, fewer jobs and a further sag in our already ailing economy.

Other energy resources suffer too. Wyoming has substantial oil and natural gas, but it is also the second largest coal producer in this Nation. As oil, the gold standard of the Btu business drops, so, too, do the values of coal and natural gas, as well as interest in emerging yet expensive projects, such as enhanced oil recovery, cogeneration and even clean coal technology.

I have been a student of energy policy for many years, and I have studied the various tools for assuring Americans an independent energy supply. After reflection, I would generally conclude that taxes on energy consumption are ungainly tools for implementing a rational energy policy.

Development and conservation tax incentives, along with an emergency supply provided by the strategic petroleum reserve, seem better methods of securing energy security and market viability.

Some might say that an oil import fee is just another attempt to smother free market forces coming into play. And this may be one concern that we will explore today.

As we all recall, government efforts to prevent free market forces from establishing oil prices began in earnest in the early 1970's as the OPEC cartel came into dominance. In its rage, Congress imposed the windfall profits tax which assured that the free markets would never really operate.

Some members who now assert that the new lower prices should now be passed completely on to the consumer, are the same ones who imposed the windfall profits tax which deprived those same consumers of some $77 billion in energy savings over the course of its existence.

They may also be the ones who continue to impose other special taxes on energy, like Superfund and black lung.

Congress has, over the years, dealt in harsh inconsistencies with the energy industry, and the American consumer has continually paid the price. In spite of ourselves, we have made tremendous strides in reducing our reliance upon foreign oil, on conserving energy in our homes and industries. Still we are traveling toward the 21st century without an energy policy that is either farsighted or cohesive.

What policy we do have has been developed in drips and drabs at the whims of individual Members of Congress and by 45 or so different government bodies. The inconsistencies in congressional energy policy are well documented and truly outrageous. We have been in and out of natural gas; first, regulating and then partially deregulating it. We have been in and out of synthetic fuels. First, funding it and then draining it away.

And, today, we are on equally dangerous ground. And I trust we will all tread carefully as we again consider the taxation of energy. I challenge Congress to some consistency, and I doubt that Congress will like it. One can no more make revenue policy without regards to its ultimate consequence than one can make energy policy with only revenge in our hearts.

Now we have two members of this committee who wish to make opening statements. And I will call first on my colleague from Rhode Island, Senator Chafee.

Senator CHAFEE. Thank you very much, Mr. Chairman. And first of all, I want to thank you, Senator Wallop, Mr. Chairman, for calling these hearings on the taxation of oil petroleum imports. I am very anxious to have the committee examine these various proposals so they can see how bad they all are.

Now whether an oil import fee is structured as a flat dollar fee on an imported barrel of oil, or a floating fee designed to keep a floor under the price of oil, I am opposed to it.

These proposals are a bad idea for Rhode Island, for New England and, I believe, for the Nation as a whole, Mr. Chairman.

Now if I were to propose a bill requiring the citizens of Oklahoma or Alaska or Louisiana to pay 5 percent higher Federal taxes than the citizens in other States, the cries of indignation would roll across this Capitol. I think we would all recognize the unfairness of that.

Yet that is precisely what advocates of an oil import fee are proposing for the citizens of my State and of New England as a whole. They are proposing taxes higher than citizens elsewhere in this land would have to pay. I am deeply disturbed over this proposal, and I suppose I could go so far as to say, indeed, I am outraged.

And, Mr. Chairman, I certainly will fight this proposal with everything I have.

Now an oil import fee, first of all, as I say, is unfair. New England leads the Nation in energy conservation, but we still depend on oil for fully two-thirds of our energy needs, a figure which is nearly double the national average.

Because an oil import fee would raise the cost of all petroleum products, foreign or domestic, it would deal a savage blow to the homeowners and the businesses of my State. The average citizen of Rhode Island now pays over $1,000 a year to heat his or her home with oil, while a homeowner in Ohio typically pays only $800 a year to heat a house with natural gas.

A $10 oil import fee would raise a Rhode Islander's annual fuel bill by nearly $240. This is unfair to New Englanders to bear the brunt of such higher costs for this basic commodity of oil.

An oil import fee is unfair to business as well. Maintaining artificially high domestic energy costs through an import fee would erase any competitive advantage our recovering industries have gained in the last few years. We have just seen our way through a difficult economic recession. Many industries, such as manufacturing, are still struggling, and foreign competition, as we all know, gets tougher every day.

Do we really want to compound our trade problems with an oil import fee? In Rhode Island where industries are already paying more for energy than any other State, the effects of this fee would be devastating, endangering hundreds and perhaps thousands of jobs and perhaps pricing our products out of world markets. That is the first reason I am opposed to it. It is unfair.

Second, an oil import fee is a completely inefficient way of raising revenue. Such a fee, by definition, would not apply to domestic oil. Yet domestic oil prices would certainly rise to the price of imported oil. With a $10 per barrel import fee, U.S. consumers would pay $58 billion more each year in additional energy costs, but the Federal Government would not collect $58 billion, but would collect less than $16 billion in additional taxes.

The reason for this inefficiency is simple. Imported oil makes up approximately 28 percent of all oil, but the oil import fee would cause the rise of the price of oil, all oil. However, for every dollar of increase in the price of oil, the Federal Government would only collect $0.28.

We might actually realize more revenue from an expanding economy, if oil prices were to fall to sustained low levels. Some economists have stated that for every $5 the price of oil drops, the Consumer Price Index will fall 1 percent, and the GNP will grow by 0.6 percent.

If we intervene to artificially keep the price of oil high by imposing an oil import fee, the Federal Government will lose any revenues that might flow from the increased growth of the economy caused by the falling energy cost.

Lower energy costs can mean lower inflation, an increase in per capita income, and more jobs for all Americans. Let us not intervene to keep this from happening.

Most economists agree that an oil import fee is a bad idea. And I think, Mr. Chairman, you have sat through these hearings, as have I, and finding economists who agree on anything is extremely difficult.

Earlier this month, I personally asked four economists that were before us—Martin Feldstein, Charles Schultze, Norman Ture and Alan Auerbach—who were appearing before this committee, as you remember, in connection with tax reform—I asked them about an oil import fee. They did not agree, as I said, in much in their testimony. However, they all agreed the oil import fee is bad economic policy, and they all agreed that if we let the price of oil fall, it will be good for the economy.

The Federal Reserve Chairman, Paul Volcker, has also stated that he opposes an oil import fee.

I hope we will have testimony from others who will agree with these experts.

Finally, an oil import fee makes a mockery of tax reform, Mr. Chairman. It is being proposed by some as a way to raise revenue to finance the continuation of the loopholes which the committee evidently does not choose to close. These loopholes include tax incentives for the oil industry, such as expensing of intangible drilling costs and percentage depletion. To obtain a reduction in rates, a new tax is proposed; namely, some are suggesting this oil import fee.

Now this, to me, is ridiculous. Any additional revenue from new taxes should be allocated to reducing the deficit, not to financing continuing tax rates or a lower rate. That is what tax reform is all about—getting lower corporate and individual rates. And to finance that by an additional brand new tax just does not make sense.

We should not be increasing energy costs to all consumers in order to "pay" for tax incentives available to a few.

If the committee or the Senate itself insists upon including this unfair and damaging proposal in a tax reform bill, I will do everything within my power to resist it.

Now that the price of oil is finally declining, the American consumer should be allowed to benefit, and that includes Rhode Islanders.

Thank you very much, Mr. Chairman.

Senator Wallop. Thank you, Senator Chafee. I will put you down as doubtful. [Laughter.]

Senator Chafee. A strong letter follows.

Senator Wallop. Just in passing, do you happen to recall which side of the fence you were on in the windfall profits tax?

Senator Chafee. I probably was for it, Mr. Chairman.

Senator Wallop. Probably for it. Well, that was $77 billion that you took out of the same consumers' pockets, including those in Rhode Island. It was never assessed against the industry. It was always paid for by the consumer.

Senator Bentsen.

Senator Bentsen. Mr. Chairman, does anyone really believe that Shiek Yamani, the Saudi Arabian Oil Minister is driving down the price of oil today because the Saudi's want to keep it down? Is anyone really that naive? Don't they understand that what the Saudi's are trying to do is to whip into line the members of that cartel, to discipline them. And once they get control again, then they will really put high prices to us. Have we forgotten the oil embargo of 1973? Can't we do anything but look to tomorrow? Can't we do any long-term planning in this country? Don't we understand we can't afford to get hooked on foreign oil again?

We are the world's biggest consumer of oil, far ahead of anyone else. We are also a big producer of oil; 8.9 million barrels a day, last year, roughly twice the production of Saudi Arabia today. And that is even after their recent boost in output.

We are second only to the Soviet Union in oil production. I will guarantee you, though, that you will see U.S. oil production decline this year. The question is only how far.

We have already seen the marginal wells start shutting down because it is no longer economical to continue pumping. And once you stop pumping one of those small wells, the chances are that that reservoir is going to collapse—you have lost it; it is gone.

We have pumped a lot of oil in this country, but remarkably, our crude reserves were more than 6 billion barrels higher 2 years ago than they were in 1949. That is because of the continuing search for new oil, and the development of sophisticated and expensive techniques for squeezing more oil out of existing wells.

The search for new oil has declined sharply in recent years, though. Half as many wells were drilled last year as in the peak of 1982. And that number is going to plummet this year.

This week, for example, Amoco announced it is going to cut its exploration in 1986 by one and a half billion dollars. And our crude reserves are already down from 2 years ago, since they included over 2 billion barrels of oil that can be recovered only through enhanced techniques that are economical at higher prices.

The decline in exploration guarantees a further decline in reserves 2, 3 and 4 years from now. You can just forget about alternative energy sources. You can forget about converting coal to oil. Shale oil is out the window. The Great Plains gasification project in North Dakota has been declared a disaster.

We made great strides in energy conservation and energy production, in recent years. But you can forget all of that if we fail to respond to the "loss-leader" flood of cheap oil from OPEC.

You are already seeing the change in attitude in this country. And you have seen it in the administration, because they have backed down from tough requirements for automobile fuel efficiency and rules to increase that mileage for a gallon of gas that is consumed.

So we are headed away from conservation, and you are going to accelerate that without an oil import fee. You are going to get away from the idea of moderating those thermostats in the winter, and keeping them up in the summer for additional conservation.

What is happening to the price of oil today does not have anything to do with the free market. It has everything to do with decisions made in Saudi Arabia. It is an OPEC decision. They turned the spigot off in the Arab embargo of 1973, and they turned it up several turns in the production wars of 1985. Does anyone here believe that they are going to keep that price down once they get control of the situation? Are our memories so short that we are going to again put ourselves at the mercy of OPEC?

Last year, we imported only 31 percent of the oil we used. It was down to 28 percent if you look just at crude. Now that was compared—and my colleague did not mention that—that was compared with 47 percent in 1977.

But that pendulum will start swinging back this year, and there is no way to stop it. The price plunge has already assured it. We cannot slow it. But we can begin the process of turning it around again.

What happens, though, in the meantime without an oil import fee is you stack the rigs. Exploration and shipper people go out of the business. Bankruptcies take place. A lot of the oil reservoirs will collapse. And you will not have shipper well production available to you to try to protect against rising oil imports.

Oil refineries in this country have been buffeted by a combination of circumstances in recent years. Oil producing countries give subsidies to their own refineries. Europe and Japan put up barriers to those refined products. So subsidized oil products have been flooding the United States. And as a result, we have seen operating refining capacity decline in this country by 3½ million barrels a day since 1981.

A study last year by the Center for Strategic and International Studies at Georgetown University concluded that our remaining 14.6 million barrels a day of refining capacity is just not enough to respond to a military mobilization involving the United States and the NATO forces.

We will raise national security risks if we fail to respond to the flood of cheap OPEC oil by putting an oil import fee in place. There is no question but we will soon see the same serious national security implications develop with regard to oil production that we have already seen for refineries.

Plunging oil prices have produced a gusher of optimistic economic projections for coming months. But I think we will see more bad economic news than good news in the short term. Moreover, we should be looking at what is in the long-range benefits for our country—whether we are talking about Texas or Rhode Island, New England or the West. We ought to have learned from the past. We ought also to be able to look back far enough to recall the last time that we were hooked on foreign oil, and then try to take some rational steps to avoid repetition.

Thank you, Mr. Chairman.

Senator WALLOP. Lloyd, thank you. Just to jump the gun a little on some of the warnings that you laid out in there, I would note that we in recent years dropped down to the point where only 28 percent of our oil consumption was with imported oil. This past year, we were at 32 percent, a 4-percent increase, and it is climbing already this year. And to give some emphasis to your remarks on abandoning some of the conservation procedures, I would note that yesterday a letter went out from GSA both raising the heating temperatures in public buildings and lowering the cooling temperatures for summer. So already we are sliding into that area where our only reaction is ultimately going to be another set of rage.

Senator Mitchell.

Senator MITCHELL. Thank you very much, Mr. Chairman, for the opportunity to be here this morning.

I join Senator Chafee in strong opposition to an oil import fee. In my judgment, it would be hard to find a less economically or socially defensible tax proposal. The obvious attraction, that it is a tax which can be hidden from the American people because of declining oil prices, is a key to all that is wrong with it.

Whenever we are asked to support a tax increase, on the grounds that the public will not notice it, we should be on our guard, because it is then likely to be a tax increase that cannot be defended on economic, budgetary, or policy grounds. An examination of the proposed oil import fee reveals that it suffers from all these defects and more.

Its economic effect will be to raise the price of a commodity which is so important to our economy that it would increase the rate of inflation by a full percentage point all by itself.

Its budgetary impact will be zero because the President insists that a tax increase can be used only to keep his tax proposal revenue neutral; not to reduce the deficit.

And its policy implications are clear. It would be a windfall for domestic oil producers, which would exceed by three or four times the revenues collected by the Government.

It would be a regressive tax levy falling hardest on people in the lowest income brackets. It would be an artificial Government-sanctioned price prop that would burden every business and industry which uses that commodity.

The domestic imperatives driving this idea are clear, but they are not persuasive.

The oil producing States want to find a way to bail out the oil industry from the steep price decline of recent weeks. But why is this declining commodity price special? It is a fundamental fact of free markets that prices can move down as well as up. Why should

Government try to institutionalize a price whose level was artificially established at a higher level in the first place?

The argument that the oil producing States are suffering a decline in income is not a sufficient reason to saddle the rest of the Nation with the cost of maintaining their income.

The other pressure driving this oil import fee is the perceived need to preserve some corporate and individual tax breaks that now exist, but which may be reduced by the tax reform bill. But what kind of a tax reform is it that preserves special privileges for the few by imposing a regressive tax on the many? That is not tax reform. That is unfairness of the most blatant kind.

The poorest one-fifth of the American people spend four times as much of their income on energy as the wealthiest one-fifth. To impose additional costs on these wage earners to pay for tax benefits for the top income groups in the country is simply to tax lower- and middle-income Americans to the benefit of higher-income Americans. That would not reform our tax system; it would further deform it.

This levy also has supporters among those who think the President's opposition to increased taxes for deficit reduction will somehow be lessened if the increase in tax is in the form of an oil import fee rather than in some other form.

That is an allegation unsupported by any evidence. The President has been as clear as he can be. He says he wants his tax reform bill. He insists on the $50 to $125 billion in tax breaks that he seeks to preserve. He wants to maintain his defense buildup. He does not want higher taxes. He has said that any tax increase would be vetoed on arrival.

Those who see in this some sign that an oil import fee could be used to reduce the deficit have seen something that eludes me and most other observers. There is simply no indication that deficit reduction is a Presidential priority and passage of an oil import fee will not make it one.

Oil is a commodity which has been granted special treatment by our Government for many decades. Before the OPEC price gouging that ripped through our economy in the last decade, the Northeastern part of the United States, which relies largely on imported oil, was subjected to an import quota which artificially propped up oil prices for 20 years. During the heyday of OPEC price gouging, the Northeast lost jobs, lost income, and lost revenues as the billions in higher prices surged to the producing regions.

Now that the effects of increased production and declining consumption are finally offering some hope of price stability, we are again faced with a claim that oil prices need artificial support imposed by the Government. That claim has never been persuasive, especially in my region of the country where families spend 15 times as much on fuel oil as families living in the western part of the United States, and where heating oil accounts for three-fourths of all energy consumed.

I know that it will be alleged that there is an exemption proposed for home heating oil. But there is no way to insulate the New England home heating oil market from the price effects of an oil import fee for two reasons: Although diesel fuel and home heating oil are not the same products, they are in the same tariff category. Therefore, an importer of oil products under that category will have to certify that the product is exempt home heating oil rather than diesel fuel. There undoubtedly will be widespread cheating and enormous problems of enforcement.

But that is the minor part of the problem. The real problem is that prices will rise to the level of the product that is in greatest supply. Over 90 percent of the New England home heating oil now being used is refined in the United States. That leaves approximately 10 percent which is imported product. The 90 percent refined in the United States will not enjoy the exemption. Inevitably, the price of imported home heating oil products will tend to rise to the higher prices enjoyed in the United States.

The arguments for an oil import fee are less persuasive today than ever before. If national security, energy independence, and bank safety and soundness are issues that need to be addressed, then Congress can and should deal with these problems directly, not directly, through an oil import fee.

And to claim that this commodity price support mechanism, which is what an oil import fee would be—a price support mechanism—ought to be part of a tax reform effort is simply perverse. Tax reform is more than an exercise in lowering tax rates. It should be a vehicle to reduce distortions between different kinds of economic activities so that businessmen operate on the basis of economic incentives, not tax incentives. What this oil import fee would do would be to add a distortion; not eliminate one.

It is indefensible tax policy and it can be by no stretch of the imagination described as tax reform. This Nation will enjoy the substantial economic benefits that flow from a sharp decline in the price of basic commodities, benefits that will dwarf any stimulus we could provide through the tax code. It would be folly for the Congress to attempt now to reverse those benefits through an oil import fee; a regressive, regionally unfair, economically unfair and burdensome tax that ought not to be adopted.

I thank you very much, Mr. Chairman.

Senator WALLOP. Thank you, Senator Mitchell.

Senator Boren.

Senator BOREN. Thank you very much, Mr. Chairman.

I appreciate the opportunity to participate in these very important hearings, and I commend you for participating in calling them.

I certainly agree with earlier statements which you made that we must move to take advantage of our current energy planning opportunities, and use this opportunity to honor our responsibility to provide for America's future energy security.

When Harry Truman was President, he used to have a saying hanging on the wall of his office from Mark Twain. And it said, "Always do right. It will gratify some people and astonish the rest."

I think it is time for us to astonish the country and for a change look beyond the ends of our own noses, look beyond our short-range usual view of 2 or 3 months out into the future, and perhaps even look as far as a year or 2 or 3 or even 5 years down the road in terms of what is good for this country. And to also realize for a change that one region of the country is not well served when any other region of the country is suffering or contributing to economic instability.

We have certainly learned the lesson in our part of the country that you cannot sustain a boom if other parts of the country are in trouble. As a member of this committee, I tried to take the national view when other regions were suffering. For example, we had proposals for trade adjustment assistance, other forms of economic policy that would have helped to restore health to those regions of the country that were suffering.

It is time for us not only to take a long-range view. It is time for us to take a national view and to realize that no region of this country can insulate and isolate itself from the economic difficulties in any other region. We are all Americans, and we should look at what is good for our whole Nation and what is good for our national economic policy. We should try to find a policy that is not only right for Oklahoma or Texas or New Mexico, but one that is right for Maine and Rhode Island as well.

And I happen to believe that this proposal for an oil import fee at this particular time is sound national policy for the good of all of us and for the good of our economy.

It is appropriate that one of our goals should be to place a safety net under the price of domestic oil so that we will also protect the financial system against the shock of further decreases, sudden decreases, in the price of oil.

The value of oil reserves is used as security for billions of dollars in loans to American banks. Some estimates have been as high as $160 billion. That would mean that the amount of debt to American banks in this country collateralized by the value of oil in the ground is roughly equivalent to the amount owed to American banks by the entire Third World.

We have had a lot of focus on that particular problem. We have been told that if the Third World were to default on its basic debt to this country that it could plunge the entire globe into economic chaos.

How is it then that we are so shortsighted that we cannot understand the danger to the financial system when you talk about cutting in half the value of the collateral for some $160 billion of debt owed to banks all across the country?

It is interesting to note that as a result of the recent dramatic drop in the price of oil, losses to the Federal Deposit Insurance Corporation on four loans it acquired from the Continental Illinois National Bank and Trust Company, for example, have exceeded $1.5 billion. The FDIC has only $22 billion in reserves. And if one midsized energy-related bank failure—we remember that situation. It began with the Penn Square Bank—could cause a $1.5 billion indirect loss to the FDIC. What would happen if the value of $160 billion in collateral in bank loans is suddenly called into question?

I can tell you that the ripple effects will not just be felt in Dallas or Houston or in one region of the country. They are going to reach the money centers in Chicago, New York and elsewhere. And it is not in the national interest—I am not talking about any region. It is not in the national interest of this country to destabilize the banking system in such a sharp way.

There are those who argue that an oil import fee would slow economic growth, cost the economy jobs and cause inflation to increase by as much as 12 percent. But what opponents of a fee fail to consider in that discussion is the disruption that will occur in our economy in the long run as a result of the sudden collapse in the price of oil.

We are not witnessing a normal supply and demand market reaction. We have heard that in real markets prices can go up and down. Of course, this is not a real market. Prices are being manipulated to bring it below the cost of production very directly by one or more governments. We are caught in the middle of a life and death struggle for market shares. Unfortunately, because most foreign oil companies are closely tied to their governments, they won't make the normal economic decisions. As the price of oil approaches the cost of production, those producers who don't benefit from favorable government policies will be the first to have to plug their production.

Should the price of oil stabilize around $15 for barrels, drilling expenditures in the United States will drop by 50 percent. The immediate impact, obviously, is lost jobs in the oil and gas and related industries. Some estimates have ranged as high as 600,000 jobs in the immediate first period alone. More importantly, though it means fewer wells will be drilled in the next year, it also translates in the need to import more crude oil and petroleum products. Almost $9 billion in additional imports projected for next year alone, only in the first year, if the price were to stay at this level.

Now half of our trade imbalance already is due to the amount of oil that we import. How in the world is it in the national interest of this country to have to increase the trade imbalance more by importing more and more of our oil? How is it in the national interest to move back from the level of some 34 percent of imports in terms of the oil we use in this country back to a level above the 50-percent mark or higher?

I have often said that if the leaders of OPEC really wanted to gain total control of the markets, they would drop oil prices below our lifting costs or our production costs, which, including taxes, range from $12 to $18 per barrel in this country.

In my State, it takes about $16 to lift and produce a barrel of oil. Now if OPEC were really smart, and they wanted to destroy the domestic industry of this country and other competing countries, they would simply force the price of oil below those lifting costs and hold that price there long enough to wipe out our domestic industry; to wipe out the infrastructure that goes along with it.

And we all know that it is not easy to recreate an industry once it is destroyed. Recreating our ability to produce oil in this country is not like turning on the water taps. It takes years to rebuild that infrastructure once it is destroyed.

Now once we allow ourselves to be put in that position, and once we fall into the OPEC trap, then you talk about artificiality in oil prices. We would put OPEC in the driver seat so that they would be in a position to raise the price of oil to unreasonably high levels any time they should choose to do so because we would be totally dependent upon them.

As Senator Bentsen asked, when in the world are we ever going to learn the lessons of history? We are not even talking about the lessons of history a century old. We are talking about the lessons of the last decade when we learned what happens when we have an embargo imposed and a shortage of foreign oil, and the price goes through the ceiling. That was not in the best interest of anybody in this country. It was not in the interest of anybody in Rhode Island. It was not in the interest of anyone in Maine or New York or California or any place else.

Think of what it would do to our national security interest. Consider what it would mean to American consumers if we allow this to happen.

We sit back here and just take the short-range view, 2 or 3 months, into the future, and do not look even 2 or 3 years out into the future. Think of the position in which we could put American consumers and our national security. By falling into the OPEC trap, we will absolutely make ourselves hostage to any kind of action that they want to take.

And I think those consumers will be back demanding, if we allow ourselves to do this, to know the names of the shortsighted Members of Congress who allowed this country to fall into that kind of trap; who allowed them as consumers to be totally dependent on foreign producers for the source of their oil.

I hope we will not so quickly forget the lessons of recent history that we should have learned. We also have to consider that once the full impact of falling oil prices is passed through to consumers, I have no doubts the consumption will again begin to rise and that we will lose the gains that we have made from conservation in recent years.

And so I think we need to stop and think. We need to think about what is in the national interest. We also have to think about what is fair. An import fee is fair tax policy and it will help promote energy independence.

Domestic oil producers pay the windfall profits tax as well as State severance taxes, as well as income taxes more fully than any foreign producers. Foreign producers do not pay it. Why should our tax policy continue to encourage the creation of jobs for exploration and refining in other nations instead of the creation of jobs here at home.

Mr. Chairman, I will just insert into the record the balance of my statement. But, again, let me just close again by making an appeal to what is in the national interest. Let us not divide ourselves along lines of whether we are from New England or whether we are from the Southwest or whether we are from the west coast. Let us ask ourselves the question about what is good for the national interest.

Is it good for Rhode Island or Maine or Oklahoma or Wyoming or Louisiana or New Jersey or any other State? Is it good for America for us to again encourage the wasteful use of energy, to encourage probable consumption, to lose our gains in conservation because we allow for a sudden, artifically induced drop in the price of oil even below the amount that it cost to produce it? Is it good for this Nation to create massive instability in an already fragile financial system that is being buffeted by sudden drops in the price of land in the agricultural sector and by a depression in the mining and timber industry and many others?

Is it good for this Nation to have our national security depend upon foreign sources for a precious commodity like oil that we would need in times of national emergency? Is it good for this Nation to further increase the trade imbalance by another $20 or $30 billion over the next 2 or 3 years. And is it good for this country to put the consumers of this country absolutely at the mercy of OPEC 2 or 3 years down the line by destroying the ability of our own producers here in this country to compete with foreign production. I go back to Mark Twain who said, "Always do right. It will gratify some people and astonish the rest."

It is time for us to do what is right, and to take a long-range view and astonish the people of the country in the process by the fact that we do look into the future for a change.

Senator Wallop. Thank you, Senator Boren.

Senator Grassley, did you have an opening statement?

Senator Grassley. No statement, Mr. Chairman.

Senator Wallop. Senator Bradley.

Senator Bradley. Mr. Chairman, I don't have any questions for the witnesses, but I thank them for their very strong testimony. I think it very clearly joins the issue for the committee and does so eloquently on both sides.

I guess my hope is that the committee will be able to make a judgment as to whether the need for an oil import fee, in a world where the price of oil is dropping and where U.S. foreign suppliers are neighbors in the hemisphere, is any different than the need for an oil import fee when the price of oil was going up and our suppliers were primarily in the Middle East.

The Congress rejected an oil import fee several years ago when the price of oil was skyrocketing and our suppliers were OPEC. I think there were about nine votes for it.

And now the price of oil is dropping and our suppliers are in this hemisphere. And I think that we need to consider if there is a changed rationale, and, if so, what, and on what basis will the Congress make a decision to reverse itself.

And I hope that the other witnesses will be able to address that.

Senator Wallop. Thank you, Senator Bradley.

Senator Long.

Senator Long. No questions, Mr. Chairman.

Senator Wallop. Senator Symms.

Senator Symms. No questions, Mr. Chairman.

Senator Wallop. Thank you all very much.

We get the statements from the administration: Hon. Danny Boggs, Deputy Secretary of the Department of Energy; and Acting Assistant Secretary for Tax Policy, Roger Mentz from the Department of Treasury.

Secretary Boggs.

Secretary Boggs. Yes.

STATEMENT OF HON. DANNY BOGGS, DEPUTY SECRETARY, DEPARTMENT OF ENERGY, WASHINGTON, DC

Secretary BOGGS. Thank you, Mr. Chairman, members of the committee. It is my pleasure to appear before you today on the question of oil imports and proposals to enact an oil import fee.

My comments will specifically address the energy policy and energy economics of import fees. You will hear from other administration witnesses on the tax policy and foreign policy implications of import fees.

Let me say that fundamentally, from the energy perspective, we believe that the primary problem with proposals for import fees is that they artificially raise the cost of energy to the economy. We do not believe that the Government can set the right price for oil when it is falling any more than we thought that it could set the right price for oil when it was rising, and it was suggested by many that price controls be imposed to set a right price.

An import fee will essentially reverse the economic benefits that have been obtained from the fall in the price of oil which has been going on, let me point out, in the United States not just over the past 2 months but over the past 5 years. Even before the latest decline, the real price of imported oil to the United States had declined by 45 percent as of the end of last year. Clearly, it will have damaging effects on our international competitiveness and on our domestic competitiveness because just as it will raise the price of products that are used in making something that is exported when that same price increase does not apply to foreigners, it has the same effect in the domestic market, which means that we will be more vulnerable to penetration from foreign imports because of this artificial increase.

Now there have been a series of proposals, some of them embodied in these two bills, some of them in others, for various types of exemptions designed to alleviate one or another of the problems. But we have to realize that each of those exemptions introduces yet further distortions into the economy and into the original set of arguments.

For example, exemptions by country not only mean that the oil coming from that country will be exempt and, therefore, we will not get the revenue from it, but it means there will be a much greater impetus to import more and more from that exempt country which further changes the initial situation.

An exemption by individual product, such as heating oil, or other product, will mean that there will be a tendency to import all of that product from abroad rather than manufacturing it at home; thereby, putting further distorting effects on the American refining industry, which in some proposals is supposed to be helped.

If there are exemptions for certain types of production, such as the production of goods for export, again, there will be a tendency to import more oil in those areas rather than buying it at home. There will be tremendous distortions between a factory which makes a product using American oil and a factory who makes one using imported oil if there is an exemption.

The market not only reacts to situations, it reacts and adjusts to these types of distortions. I have no doubt that the Energy Department and you, Senators, will be flooded with applications, schemes and proposals for adjustments of these adjustments, the very thing that led us to the entitlements program, to the enforcement problems that filled Washington with bureaucrats in the 1970's. We are still dealing with the "tail" of these programs. Setting aside what effects each of these adjustments would have on any supposed revenue.

Now let me point out that there are, indeed, pluses to an import fee proposal. Compared to most other means of intervening in the market to supposedly reduce dependence, in our view, it is one of the least silly. That is to say, it does not try to pick winners and losers among the ways to diminish imports. It just says imports are more expensive and everything else can compete.

It is true that it will mean to some extent—and these analyses are all subject to great variety—but it will clearly mean to some extent more production of oil and of other domestic energy resources and less consumption of oil.

But this is always true. It was true when oil was $40 a barrel, and it is true if oil is $15 a barrel.

Now some, I suppose, think this is fine. The New York Times has editorialized in favor of what they call an oil conservation tax and saying that it is good policy at any time. In other words, that no matter how high the price of oil is, it ought to be yet higher. I don't think that we believe that.

Energy is not a morality play in which we fight some type of sinful uses of energy. The question is allowing market signals to operate both on the production and on the consumption side. Our goal is not to reduce imports no matter how high the cost of that reduction is. Indeed, an oil import fee to reduce imports was argued for and rejected at a time when we were much more dependent. At that time, the administration said that we believed that by decontrol, by allowing the market to operate, we could bring that import dependence down and, indeed, we have.

A lot of numbers have been thrown around, and we would be happy to submit particular analyses for the record, but it is clear that the U.S. dependence on imported oil has been down since 1980. It has remained steady or down over the last several years. In 1985, U.S. dependence on imported oil as a percentage of consumption was at a 12 or more year low by any means of calculation.

The U.S. production was at a 12-year high. Our efficiency in terms of economic output per unit of energy was at a historic high.

Now this does not mean, let me reiterate, that falling prices do not moderate those effects. But certainly when we look at the statements that were made in the early 1980's about what would happen with the price decline that we have already had, it should lead us to at least be somewhat skeptical about statements that there will be a vast and immediate reversal in these trends.

Finally, I would note that an import fee would indeed hurt the oil producers outside the United States. The full effect of a $5 fee would not all be passed through to consumers because there would be some decline in the world oil price. Again, analyses may differ, but most analyses would say that $1 or $2 of the $5 would be reflected in a decline in the world oil price.

But those producers that would be hurt most would not necessarily be the OPEC producers. The reason the price would fall would be a decline in consumption and a decline to meet it in production. That decline would tend to come from the higher cost non-U.S. producers who would not tend to be the OPEC people.

This, in a sense, reminds me of the statement that was made that the Puritans outlawed bear baiting not because it brought pain to the bear but because it brought pleasure to the spectators. Now that does not seem too sensible. I would indicate that a fee for the particular purpose of hurting foreign producers without looking at the overall effect on the American economy would not be sensible either.

I would conclude by saying, however, that none of this means that we do not still need to do the sensible things that we can do to continue to improve America's energy situation. These are things that we should have been doing all along—natural gas decontrol, nuclear licensing reform, sensible regulations in the energy area.

I would certainly urge any of those who have had a sudden access of support for the free market based on what has happened in oil prices to examine some of these sensible things that we should have been doing already and for which we definitely should not slacken our efforts to do because of an oil price decline.

Thank you, Mr. Chairman.

Senator **Wallop**. Thank you, Mr. Boggs. I am going to ask Acting Secretary Mentz to give his testimony, and then we can question them as a panel.

[The prepared written statement of Secretary Boggs follows:]

Statement
by
Danny J. Boggs
Deputy Secretary
U.S. Department of Energy

Before the
Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation

February 27, 1986

Mr. Chairman and Members of the Committee, it is my pleasure to appear before you today on the question of oil imports and proposals to enact an oil import fee. My comments will specifically address the energy policy and energy economics of import fees. I will defer to others on the tax policy implications of import fees.

Introduction

Various energy taxes have been suggested to reduce payments to foreign energy suppliers, or to curtail U.S. foreign energy dependence or to aid domestic energy producers or to raise federal revenues. Because energy taxes have such far-reaching consequences in the national economy, the proposals have proven very controversial. The inescapable conclusion is that any energy tax, no matter what its specific form, raises energy costs in the economy. A fee on oil imports of $5 per barrel would raise costs to U.S. consumers. A fee would make it more difficult for domestic industries to compete with imported manufactured goods, and for U.S. exports to compete in foreign markets.

While all estimates should be taken with caution, and are only indicative of wide ranges, our analysts estimate that a $5 import fee would increase U.S. oil prices by a somewhat lesser amount, perhaps $3 per barrel or more beginning in the first year. This price increase would reduce consumption and raise the revenues of domestic producers, and eventually tend to stimulate or maintain U.S. production by about 100,000 to 200,000 barrels per day above levels that would otherwise prevail and increase use of U.S. and Canadian natural gas. The overall effect would be to reduce current net oil import demand of about 4.3 million barrels per day for crude oil and products combined by perhaps 600,000 to 800,000 barrels per day, beginning in the first year. Consumption of petroleum would fall by a smaller amount than the reduction in imports, since supplies of other oil substitutes would increase in the face of increased market prices. U.S. oil prices will not rise above current price levels by the full amount of the $5 per barrel import fee because the fee will reduce U.S. imports and cause world oil prices to fall. It is important to recognize, however, that after imposition of a $5 per barrel fee, U.S. prices will be above future prevailing world oil prices by the full amount of the fee. Thus, U.S. consumers and energy intensive industries will suffer a competitive disadvantage relative to our trading partners that is fully equal to the $5 per barrel fee.

The import reduction would probably come largely at the expense of non-OPEC producers, whose costs are generally higher than those of the OPEC producers. It is therefore questionable whether the fee would significantly improve U.S. energy security. We are not sure whether imposing a higher fee on refined products would improve energy security either, since it would merely shift imports from products to crude oil. In addition, there is ample excess refining capacity available throughout the world in the unlikely event that certain foreign refinery operations were disrupted but crude oil supplies to the U.S. were not. For example, if all refined product exports from the Middle East and North Africa ceased, it would take only about a 4 percent increase in the utilization of other free world refining capacity to replace these refined product supplies. By restricting access to foreign petroleum products, an import fee would raise U.S. energy costs, by reducing competition from foreign refineries.

Energy Effects

An oil import fee would raise oil prices and reduce oil consumption in the U.S. The fee would reduce oil imports by an even larger amount than the consumption drop, because the fee would also increase domestic production of oil and natural gas, and increase imports of natural gas. The revenue gain from an import fee would be small compared to its price impact on the economy through higher energy prices, because the import fee would only apply to about 20 percent of U.S. oil consumption and 10 percent of total energy consumption. Imposition of the fee, however, even only on imports, raises the price of all energy commodities. Therefore, the inflation impact of the fee reflects price increases on all domestic sources as well as the added tax liability on imports. Because some Federal budget expenditures are indexed to the price level, future spending increases may take up a significant part of import fee revenue. Higher energy prices would also reduce GNP growth, and consequently reduce tax receipts from regular sources, possibly offsetting most or all of the direct receipts from an import fee.

Imposition of a $5 per barrel fee on oil imports would raise prices on domestic oil production. Since foreign oil is our marginal energy source, the landed cost of foreign oil sets the price for domestic production. As the cost of imported oil rises, natural gas becomes more attractive as an alternate fuel. Demand for gas from both domestic production and Canadian imports would rise, increasing their price.

An increase in domestic oil production, coupled with increased use of natural gas and decreased energy consumption, would reduce import volumes, and measurably reduce anticipated import fee revenue. Even modest shifts in consumption patterns following imposition of an import fee could reduce import levels by 600,000 to 800,000 barrels per day, beginning in the first year, with a commensurate reduction in the initially anticipated revenue base.

DOE's analysis of the import fee at $5 per barrel indicates that world oil prices could likely fall by perhaps as much as $1.25 per barrel by the end of the first year, and $2 per barrel by 1990. Because a fee would lower world oil prices somewhat, prices to U.S. consumers would rise by approximately $3 to $4 from current levels. U.S. oil production would rise by up to 200,000 barrels per day, following imposition of a $5 per barrel import fee. At the same time, oil consumption would fall by about 200,000 barrels per day due to price effects, and 300,000 to 400,000 barrels per day due to fuel switching.

The fee would likely affect high cost producers more than low cost producers. Since most of our imports now come from Canada and Mexico the fee is likely to reduce imports from non-OPEC nations rather than reducing OPEC sales. The fee is not likely to reduce significantly our or the world's dependence on OPEC suppliers.

In the context of the current oil market, we see little national security risk from the current level of oil imports. Market prices are low by recent standards and sources of supply are diverse. Furthermore, there is excess production capacity available in widely separated producing regions, and the Strategic Petroleum Reserve now stands ready to protect our economy against any foreseeable near-term supply interruption. Thus, the import fee cannot be justified in the current market by the need to curtail imports.

The principal remaining rationale for the import fee is to bolster the domestic oil industry. We do not dispute the difficult financial conditions that the domestic industry has experienced with falling oil prices, but the limited respite that producers can be granted from the realities of world oil pricing does not justify raising costs to all domestic oil users. The Department has concluded that an oil fee is simply not a wise energy policy, in the absence of overriding national security concerns.

Energy Security Effects

In discussing energy security, it is useful to distinguish between oil supply vulnerability and oil import dependence. Even if our economy were self sufficient in oil production, a supply disruption elsewhere in the world would raise energy costs in the U.S. Our exposure to higher oil costs is not limited to the level of our imports, so long as trade is unrestricted. Our economic vulnerability to higher oil costs is related to our dependence on oil, not our purchases of imports or their source. The difference is important because while we all may agree that improving energy security is a worthy objective, we may differ considerably in terms of how to achieve that objective.

A significant drop in world oil prices will likely stimulate U.S. oil consumption and, in the long run, discourage U.S. oil production so that net U.S. oil imports increase--including U.S. imports from unstable Middle Eastern countries. However, this does not necessarily increase our vulnerability to an oil supply disruption, as long as we have adequate strategic stocks. An oil import fee intended to reduce our dependence on Middle Eastern oil may actually result in little reduction in our future vulnerability to oil supply disruptions.

In summary, we can harm foreign oil producers by imposing an import fee--but only at the cost of direct economic damage and loss of competitive position relative to foreign economies.

Even if the U.S. imported no oil, price increases caused by supply disruptions would impose large costs on our economy. Certain sectors (e.g., agriculture, chemicals, petrochemicals and the automobile industry) would suffer unemployment and idle resources due to large oil price increases. In addition, the effect of a disruption on our import dependent trading partners would be transmitted back to our economy in the form of reduced demand for some U.S. exports and higher prices for goods imported by the U.S.

The most effective energy security policy is to maintain an adequate strategic oil stockpile (as we do in the U.S.) and to encourage other oil consuming countries to increase their stockpiles to reasonable levels and to encourage flexible response measures for use in the event of an oil supply disruption. Such flexible policies would include a market response to higher oil prices or to lower oil prices.

Mandatory Oil Import Program

The proposed oil import fee brings memories of an earlier era. From 1959 to 1973 the U.S. imposed an import quota under the Mandatory Oil Import Program (MOIP) that elevated the price of oil in this country above market levels. The MOIP quotas are blamed for rapid depletion of domestic oil reserves, and for placing U.S. manufacturers of durable goods at a competitive disadvantage relative to manufacturers in other major industralized trading nations that had access to cheaper foreign crude oil. Estimates of the costs to consumers due to higher petroleum prices caused by the import quotas range from $4 to $7 billion per year from 1959 to 1973. The import quotas were replaced by a system of fee-paid licenses in April 1973. In 1979 the import license fees were suspended to lower the cost of imports following the Iranian Revolution. In 1983 the import fees were dropped entirely.

Revenue Effect

Mr. Roger Mentz, from the Department of the Treasury will provide greater detail on revenue issues. I would like to note, however, that responses to higher U.S. oil prices will engender fuel switching and increased U.S. production that will, in turn, reduce import levels by 600,000 to 800,000 barrels per day. Therefore, actual revenues will certainly fall short of the $7.8 billion per year suggested by current import levels of 4.3 million barrels per day.

Proposed Fee Differences for Crude Oil and Products

Senate Bill 1507 would tax imported crude oil at $5 per barrel, but levy $10 per barrel on imported refined products. The differential fee would raise the price of refined products in the U.S. markets more than the increase for entering crude oil. This measure would not only raise wellhead prices, but it would benefit refiners by increasing profit opportunities for domestic refiners. The higher fee on products would raise refining costs by reducing the benefits of competition. As I described earlier, the higher fee may not improve energy security. We would import less refined product but more crude oil and domestic refineries would operate more intensively. But the major energy security problem that we and other consuming countries face is the potential loss of crude oil supplies, not refined products.

The added levy on products could be costly to the national economy by raising the cost of imported products sometimes needed to balance sudden fluctuations in product demand. As recently as February 1984, the U.S. imported heating oil to combat a price increase that occurred when domestic refiners were caught short by a sudden cold spell that both increased heating demand, and temporarily shut down some Gulf Coast refineries. Quick access to reasonably priced imports is often important to our own energy needs.

I should add that import fees may be inconsistent with our stated position within the International Energy Agency (IEA) to allow product trade in response to market forces.

Proposed Fee Exemptions

Certain proposals for the oil import fee would exempt specified oil users of certain oil producers from the import fee. These exemptions would soften the impact of higher oil prices in certain price-sensitive uses. As was noted earlier, export manufacturers would be adversely affected by higher energy costs. An exemption from the oil fee for the manufacture of goods for export would not fully remove this disadvantage. Users of oil for residential heating might also plead financial hardship and win an exemption. Every exemption granted would reduce the revenue yield of the fee, and would create an incentive to buy imported oil for the exempt use, or to import from exempt sources. If widespread exemptions were allowed, the fee might prove to have little of its intended revenue effect. Furthermore, the administrative task of managing fee exemptions, and the need to prevent use of exempt oil in non-exempt uses, could prove immense. Enacting widespread exemptions from the tax would raise many enforcement problems reminiscent of the entitlements period. Indeed, five years after President Reagan decontrolled the oil markets, we are still prosecuting violations of the former petroleum price and allocation control program.

Exemptions would give rise to complaints from non-exempt users that they were being unfairly denied the same cheap oil that others were getting. Granting country exemptions would also provoke complaints about unequal treatment and violation of earlier commitments to free trade. Separate treatment for Canada and Mexico would raise problems with Venezuela and the North Sea producers. Fee exemptions may also violate our IEA commitment to foster open energy trade and may violate other international obligations.

The definitional problems that proved so vexing in enforcing compliance with entitlement rights would be equally unworkable if enacted as import fee exemptions. In the era of Gramm-Rudman limits, we should avoid proposing or enacting provisions with built-in administrative burdens.

I would be pleased to respond to any questions at this time.

STATEMENT OF ROGER MENTZ, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. Mentz. Fine.

Good morning, Mr. Chairman. Good morning, members of the committee.

It is my pleasure to be here with you this morning to discuss the Treasury Department's position regarding the imposition of excise taxes on the importation of crude oil and refined petroleum products.

In particular, the subcommittee is reviewing S. 1507 and S. 1997, each of which would impose an excise tax or tariff on crude oil and refined petroleum products that are imported into the United States.

Before getting into these bills in detail, I would like to emphasize the administration's strong opposition to any tax increase, including any new or increased taxes on petroleum or other sources of energy, for any purpose other than as a component of a fundamental tax reform bill that is revenue neutral in total.

While the Federal budget deficit remains a major problem, the administration believes strongly that the deficit can and should be eliminated through substantial reductions in nonessential domestic spending; not by a tax increase in any form.

The administration remains firmly committed to the enactment this year of a revenue neutral tax reform bill. It is in that context, if at all, that the administration would be willing to consider supporting taxes of the type proposed by these bills.

I will describe the bills briefly. S. 1507, which is sponsored by Senators Boren and Bentsen, would increase the existing tariff on imported crude oil by $5 a barrel and the existing tariffs on refined petroleum products by $10 a barrel. The $5 additional tariff would begin to phase out when the average world price of crude as determined quarterly reached $25 a barrel and would be phased out dollar for dollar so that it would be completely eliminated when the average world price hit $30.

Similarly, the $10 additional tariff on refined products would be phased out for each product as the average world price of the particular product moved from $25 a barrel to $35 a barrel.

The increased tariffs imposed by this bill would be refunded with respect to any barrel of crude oil or refined petroleum product that was used as a heating fuel or in the production of heating fuel. In addition, the tariff would be refunded for any crude oil or refined petroleum that was necessary and inherent to the manufacture of any product destined for export. In each case, those would be implemented by Treasury regulations.

S. 1997, which is sponsored by Senators Wallop and Bentsen, would impose an excise tax on the first sale or use within the United States of crude oil or refined petroleum products that have been imported. The amount would be based on a sliding scale. For crude oil, it would equal the difference between the average world price of crude and a statutorially prescribed floor set initially at $22 a barrel.

The amount of the floor would be increased annually to take into account inflation. As in the other bill, the world price would be determined quarterly.

For refined products, effectively, the excise tax would be $9 per Btu equivalent of a barrel of crude so that in the case where a refined product had a greater Btu content, the excise tax would be more than $9 proportionately. If it were less than the Btu equivalent of a barrel of crude, the exise tax would be less. This is a well-designed sliding scale to take the Btu content into account.

S. 1997 would exempt from the tax any refined products imported for use as home heating fuel. It would also provide exemptions for residual fuel oil and for top crude oil imported for further refining, for processed fuels and for LNG.

Finally, S. 1997 would exempt from the new excise tax any crude oil or refined petroleum product that was sold for export within 6 months following importation.

Although these two bills differ in some respects, they, obviously, share the characteristics of imposing a fee on most imported oil and refined petroleum products, and, thus, they raise a series of common considerations, which I will discuss rather generally.

We face today crude prices that have fallen dramatically. Spot price for west Texas intermediate crude, for example, closed Tuesday at $14.55 a barrel, as compared to its recent high of $31.80 on November 21, 1985.

The falling price of crude and its effect on prices of refined petroleum and other sources of energy and the effect of these price reductions on both the economy in general and the particular regions of the country must obviously influence your consideration of these proposals to impose a fee on imported oil.

First, let us consider the effect of Federal revenues. As already noted, the administration has indicated its willingness to consider the imposition of a fee on imported oil and refined petroleum only in the context of a revenue-neutral tax reform bill. The President has stated that the House-passed bill, H.R. 3838, fails in several respects to meet his minimum requirements for an acceptable bill.

Many of the improvements suggested by the President as well as others that have been mentioned by members of the Senate Finance Committee, particularly at last month's retreat, would entail a significant loss of revenues. Thus, the revenue raised by a tax on imported oil could be used to maintain the revenue neutrality of a bill that included these suggested changes.

Accordingly, the revenue effects of the proposals being considered are an important factor. I might say that if you all can come up with a tax reform bill that does everything that the President wants it to do and meets your own objectives, without getting into an oil import fee, God bless you. The purpose of considering this proposal and the reason the President has got it on the table and wishes to leave it on the table is that we are concerned as we move forward in tax reform that we may come up with a revenue shortfall, and if that happens, it is appropriate to consider alternative revenue sources and certainly the oil import fee is one that has some highly attractive features as well as some negatives. I will go into them both.

The potential revenue raised by the imposition of a tax on imported oil and refined products really differs depending upon the structure of a proposal. If you had an oil import fee that was a fixed fee not dependent upon the price of oil, our conclusion is that it would raise roughly the same amount of revenue irrespective of world oil prices. Thus, if you had a $5 fee on crude, it would raise roughly the same amount of revenue whether the world price was $20 or $25 a barrel.

The two bills that are being considered at this hearing, however, establish in varying ways an import fee that is explicitly dependent upon the level of world oil prices and, thus, the revenue raised by each, unlike a fixed fee, would be sensitive to changes in the world oil price.

If we assume that the effective date of either proposal were to be October 1 of this year and that oil prices are $4 below the administration's latest forecast, which was their December forecast, and assuming all other elements of the forecast remain unchanged, we estimate that S. 1507, which would impose the $5 dollar tariff on crude and a $10 tariff on refined products, would increase revenues by approximately $35.7 billion over the 1987 to 1991 budget period. That number is different than the $41.4 billion in the written testimony.

Because the tariff is phased out as the world price of oil increases from $25 to $30 and refined products increase from $25 to $35, we would note that the revenue would not be realized if the current decline in world prices were reversed and prices started to rise.

On similar assumptions, the estimate for S. 1997 comes in at $26 billion instead of the $31 billion indicated in the written testimony. There, again, if the average world price drops more than $4 a barrel below the CEA forecast, which certainly is a distinct possibiliy in the current market, there would be a greater amount of revenue raised.

S. 1997 actually raises even greater uncertainty than S. 1507 in estimating the likely revenue effects. That is because the tariff is based on a totally sliding scale no matter what the world price of oil is. It depends more directly on the price of oil whereas S. 1507 has a fixed fee except that it starts to phase out as the price of oil gets above $25 a barrel.

Given the volatility of world oil prices, and the influence of foreign governments on these prices, it is hard to depend on this taxing mechanism really in either bill but particularly S. 1997 as a stable source of a specified level of revenue over an extended period of time.

Thus, as this analysis suggests, we must be careful not to assume that the revenue raised by an oil import fee of the types provided in either of these bills will constantly be available to maintain the revenue neutrality of a tax reform bill.

There is a high degree of uncertainty in predicting the revenue effects of any variable oil import fee. Under today's market conditions, this uncertainty is a major detriment. It has to be regarded as a major detriment of an oil import fees whose purpose is to ensure that a tax reform bill is revenue neutral.

You will note in the joint committee pamphlet, the joint committee did not estimate the revenue effects of these bills, regarding the price of oil as so inherently unpredictable as not to be subject to a reliable estimate.

National security considerations play a prime role in this consideration on an oil import fee. The tax treatment of our natural resources has long been an important element in maintaining a viable domestic energy industry, which clearly is an integral element of our national security. Thus, the effect that an oil import fee would likely have on domestic energy industry is a critical factor that must be considered.

As you know, there has been a slow, steady decline in world oil prices since 1981. This has had an impact on the domestic oil industry which includes not only production but oil drilling, well service contractors, oil tool and pipe manufacturers, and many other businesses. These businesses have been forced to adjust gradually to this decline in energy demand.

However, the rapidly falling world oil prices encountered recently, if continued, raises the possibility of a greater threat to the strength of the domestic oil industry. This will significantly affect the level of exploration and development of our domestic resources.

Indeed, as you know, several major oil companies have announced substantial reductions in their domestic exploration and production budgets. Furthermore, if the price of oil continues to fall, many of this country's stripper wells, which comprise approximately 15 percent of domestic oil production, will be made unprofitable and may be prematurely abandoned.

Because the price of other sources of energy are related to the price of oil, this reduction in exploration and development may eventually spread to other energy sources such as coal and natural gas. Ultimately, reduced levels of domestic exploratory and developmental activity will lead to reduced domestic production.

In the face of both this lower domestic production and greater domestic demand resulting from falling prices, oil imports will increase, leading to greater dependence upon foreign oil in the near term.

While a greater demand for oil will generally provide pressure for an increase in oil prices, such prices are now significantly affected by the production policies of the major oil producing nations. That is really the wild card in this whole picture. Thus, prices might possibly drop to relatively low levels before heightened demand would cause them to increase.

Many producers, drilling contractors and others dependent upon the oil industry might not be able to survive while waiting for the price to rebound.

By imposing taxes solely on imported petroleum, both of the bills under consideration today would generally increase the prices of domestic energy and refined products above the prevailing world prices. Because the prices of all energy sources are somewhat interrelated, the price of other domestic energy sources would also be increased. Thus, the effects on the domestic energy industry that are caused by falling oil prices would be relieved in each proposal.

Moreover, the higher price for domestic resources may encourage exploration and development in this country, or, at the very least, stem the reduction in such activities resulting from lower prices.

Let us consider the general impact on business and industry in general. The imposition of a tax on imported petroleum would have some clearly delineated effects. It would increase energy costs, and the result of that would have the most serious impact on industries that are heavy energy users or that rely on petroleum feedstocks. Thus, domestic manufacturers of products such as plastics, glass, cement, paper, limestone, steel, textiles, aluminum, chemicals and paint would face substantially higher costs, dependent upon what their source of energy is.

The agriculture sector, particularly farmers, also would be hurt because of the likely decrease in the cost of fuel and fertilizer resulting from falling oil prices. That would be partially or fully offset by the imposition of an oil import fee. In other words, those costs either would not decline as fast as they would otherwise or might, indeed, rise.

In addition to the direct impact, an oil import fee also would make it more difficult for many domestic industries to sell their products abroad. In other words, there would be an impact on exports. Exports would face tougher competition in two respects: One, the cost of manufacture of the domestic products for export would be increased by the higher cost of energy; and, two, because the cost of the world price of energy would be below what the U.S. price of energy would be, foreign imports would have an advantage. So there would be that impact, sort of a double-barreled impact on our balance of trade.

Each of these effects would offset the reduced imports of foreign crude oil on refined products that would undoubtedly result from the imposition of an oil import fee. Thus, we cannot really tell you which way the result would go in terms of the effect on our trade balance—whether we would have lower imports because of the effect of the excise tax or whether that would be offset or more than offset by the lack of competition of our exports generally.

Even if an exemption were provided to manufactured goods destined for export, which is contemplated in varying degrees by each of these bills, it is likely that relief would be effective only in a limited number of cases, and that the international competitiveness of many industries would, nevertheless, be negatively affected.

It is just very hard to get that relief targeted to where it belongs. Particularly a company that is not completely vertically integrated does not have the ability to take advantage of that targeted relief and provide the export incentive that is desired by the architects of these bills.

Thus, although the effects of an oil import fee on domestic industry would be generally negative, I would like to point out that the fee would encourage, it would aid, several energy producing areas. As noted, it would significantly benefit certain sectors of the domestic energy industry. It would have a major effect on the domestic refining industry. Domestic refiners would clearly benefit from a structure that imposes a higher fee on refined products than on crude oil, as both of these bills do. That would discourage the importation of refined products.

Accordingly, both of these bills would aid domestic refiners. In addition, we note that oil royalties, severance taxes and other energy-related receipts are a significant source of revenues to certain States. Certainly, the fiscal health of these States, which has been hurt by the steep decline in oil prices, would be improved through imposition of an oil import fee.

Rapidly declining oil prices also has an effect on banks, which have made energy loans. That was noted earlier by the testimony of others, certainly Senator Boren. Many of those banks have recently made provisions, additional provisions, for loan loss reserves.

Nevertheless, the continued instability of oil prices may have serious effects on such banks and could trigger bank failures.

A softening of the fall of domestic energy prices by the imposition of an oil import fee would protect those banks from declines in market price.

This effect, I would note, would be offset somewhat because some banks also would be helped out by falling oil prices and certainly banks with loans to oil exporting nations would be hurt by imposition of an oil import fee which would curtail their exports to the United States.

It is difficult to determine precisely how the energy cost resulting from a tax on imported petroleum would be distributed throughout the economy. However, it is also difficult to determine how the exemptions would work in terms of attempting to target the relief to home heating fuel, for instance.

But because prices for almost all sources of energy are interrelated and depend to a great extent on the prevailing price of oil, consumers would face increased cost through purchases of other sources of energy, including natural gas and to a lesser extent electricity generated by burning coal or natural gas.

Furthermore, consumers would indirectly bear higher costs in their purchases of all goods and services because of the higher energy costs that would be faced by producers of energy-intensive basic materials and by the construction and transportation industries which in turn would be reflected in higher prices generally.

The amount of the increase in cost to consumers is not a one-to-one relationship to the benefit to the Federal Treasury. Indeed, because there is some benefit to the oil industry and related industries and to some lesser extent other energy areas, there would be, we calculate, about $1.75 of benefit to the domestic oil industry for every $1 of tax collected by the Treasury. Thus, the oil import fee is a less efficient means of raising revenue than would be a—a more direct excise tax where it would be $1 for $1. A counterbalancing consideration, of course, is there is this effect on the domestic energy sector which may well be a desirable effect and one that is in the interest of our overall national security.

I would simply call that effect to your attention.

The distributional impact is something else that I think has to be considered, particularly in the context of a revenue-neutral tax reform bill. In the context of tax reform, not only is revenue neutrality important, but distributional effects are very important. An oil import fee is a fairly regressive form of tax. Because low income individuals tend to have a greater portion of their disposable income spent on energy than higher income individuals, the tax would result in a greater reduction in their disposable income than would be true of the higher bracket individual.

Indeed, if you look at the tables in the back—look at the bottom part of table 1 on S. 1507—you will see that even in conjunction with the reduction in tax produced by the President's tax proposals, you still wind up with an increase in burden for the lower income individuals and going all the way up to where you only get a reduction when you get to $100,000 or more.

Indeed, I think our conclusion is that this distribution is almost perfect except that we have the signs wrong.

I would say that there are ways of correcting this. One way of doing it is to provide for a change in either the standard deduction or the personal exemption for lower income individuals to target it through the income tax system. That is only partially effective because some of the low income individuals are not on the tax rolls at all so that would not do any good.

Probably a better way would be a refundable credit. We believe a refundable credit could be designed for this purpose. It has some complexities but, nevertheless, it could be fashioned to ameliorate this regressive effect.

As has been indicated previously, the regional impact of an oil import fee also has to be taken into account. The energy consumption in different regions of the country vary fairly significantly. This is reflected in table 3. An oil import fee without any exceptions would be felt most heavily in the Northeast. I believe Senators Chafee and Mitchell observed this point.

Both proposals made in these pending bills woud mitigate that disproportional regional impact by providing exceptions for heating fuel and in the one case crude oil that is to be refined into home heating fuel. Those exceptions are difficult. They provide administrative difficulties and don't provide a complete answer.

They clearly will impose bureaucratic burdens on segments of the domestic oil industry. They will really offer only limited relief to the affected people, as the table indicates.

I think, without getting into the gory detail—let us just say an administrative burden would be created by both proposals, similar to what we had when we had oil price controls. In particular, providing exemptions for crude oil and refined products imported from particular countries or for particular uses might necessitate an extensive regulatory and enforcement apparatus. Such regulation could amount to unreasonable Federal Government intrusion into the oil business, a role that we properly abandoned with the removal of oil price controls in 1981.

Indeed, a Member of the House of Representatives from an oil producing State characterized this as an effort to remove the mayonnaise from tuna fish salad.

Without getting into the effects that an oil import fee would have on other countries, which I believe the State Department will handle, and also the GATT effects, which are covered in my written testimony—and I believe also will be covered by the State Department—I would simply summarize, Mr. Chairman, by saying that there certainly are significant benefits and significant detriments that would result from the imposition of an oil import fee. The President has not ruled it out. We suggest that you keep it on the table as we get into tax reform. As I indicated before, if tax reform can be accomplished without the imposition of any kind of a new revenue raiser, that is fine with the administration. But if that cannot be done—and, indeed, that is a formidable objective—if it cannot be done, the President has made it clear that he would not foreclose consideration of an oil import fee in the context of a revenue-neutral tax reform bill.

Thank you, Mr. Chairman, for being very patient with me. We would be glad to answer your questions.

Senator WALLOP. Thank you, Mr. Mentz.

[The prepared written statement of Secretary Mentz follows:]

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STATEMENT OF
J. ROGER MENTZ
ACTING ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss the Treasury Department's views regarding the imposition of excise taxes on the importation of crude oil and refined petroleum products. In particular, the Subcommittee is reviewing S. 1507 and S. 1997, each of which would impose an excise tax or tariff on crude oil and refined petroleum products that are imported into the United States.

Before discussing these bills in detail, I wish to emphasize the Administration's strong opposition to any tax increase, including any new or increased taxes on petroleum or other sources of energy, for any purpose other than as a component of a fundamental tax reform bill that is revenue neutral in total. While the Federal budget deficit remains a major problem, the Administration believes strongly that the deficit can and should be eliminated through substantial reductions in nonessential domestic spending, not by a tax increase in any form.

The Administration remains firmly committed to the enactment this year of a revenue-neutral tax reform bill. It is in the context of such a bill, if at all, that the Administration would be willing to consider supporting taxes of the type proposed by S. 1507 and S. 1997.

Background

Tax Provisions. There are presently a variety of specific taxes applicable to crude oil and refined petroleum products. Under the Crude Oil Windfall Profit Tax Act of 1980, a Federal excise tax is imposed on certain domestic crude oil. In general, the amount of the tax depends upon certain characteristics of the oil, such as when it was discovered and its method of production, and the difference between the value of the oil upon removal and statutorily specified base prices. Because the removal price of oil has been falling, while the inflation-adjusted base prices have been increasing, the revenues generated by the windfall profit tax have been rapidly declining. 1/ The tax is scheduled to phase out over a 33-month period beginning in 1991. 2/

Imported crude oil is not subject to the windfall profit tax. Under the Tariff Schedules of the United States, however, a tariff is imposed on imported crude oil and certain refined petroleum products at rates ranging from approximately five cents per barrel on certain crude oil (0.125 cents per gallon) to 84 cents per barrel on certain refined products (two cents per gallon). A higher rate applies to products imported from certain communist countries, and some refined products may be imported from Canada without any duty. These tariffs, which are imposed under the Tariff Act of 1930, are not designed principally to raise revenue and do not significantly affect the cost of oil or refined products. 3/

Finally, Federal excise taxes, at rates ranging from three cents per gallon to 15 cents per gallon, are imposed on gasoline and other fuels. These excise taxes do not increase general revenues, but are dedicated to the Highway Trust Fund, the Airport and Airway Trust Fund, and the Inland Waterways Trust Fund. The Highway Trust Fund excise taxes are currently scheduled to expire on September 30, 1988, and the Airport and Airway Trust Fund taxes are scheduled to expire on December 31, 1987.

Energy Consumption. The percentage of U.S. energy consumption supplied by imported crude oil and refined petroleum products has been declining since 1977, when nearly 48 percent of our gross oil supply was produced abroad. By 1981, our reliance on imported oil and oil products had declined to 36 percent of domestic consumption. This trend continued in 1985, during which 31 percent of U.S. gross oil consumption was supplied by imported products. Net imports in 1985 represented only 27 percent of domestic consumption.

1/ During 1984, the windfall profit tax raised $3.9 billion in net revenues. If the average removal price during 1986 decreases to $18 per barrel, the revenue raised by the windfall profit tax will be negligible.

2/ The phase-out period could begin in 1988 if the cumulative net revenues raised by the tax exceed $227.3 billion. Under current assumptions regarding oil prices, however, we do not expect the phase-out period to begin before January 1991.

3/ In addition to the general Tariff Schedules of the United States, the President has authority under the Trade Expansion Act of 1962 to impose oil import fees or other restrictions if he finds that imports threaten national security. This authority, which has been used several times, is subject to Congressional override.

Description of the Bills

S. 1507, sponsored by Senators Boren and Bentsen, would increase the existing tariff on imported crude oil by $5 per barrel, and would increase the existing tariffs on refined petroleum products by $10 per barrel. The $5 additional tariff on crude oil would begin to phase out when the average world price of crude oil, as determined quarterly by the Secretary of Energy, reached $25 per barrel, and would be eliminated when the average world price reached $30 per barrel. Similarly, the $10 additional tariff on refined products would be phased out for each product as the average world price of the particular product moved from $25 per barrel to $35 per barrel.

The increased tariffs imposed by S. 1507 would be refunded with respect to any barrel of crude oil or refined petroleum product that was used as heating fuel or in the production of heating fuel. In addition, the tariff would be refunded for any crude oil or refined petroleum that was "necessary and inherent" to the manufacture of any products destined for export. In each case, the bill contemplates that the Treasury Department would, by rules and regulations, provide the procedures under which qualification for a refund of the tariff would have to be proven.

Finally, S. 1507 would express the sense of the Congress that the net increase in Federal revenues resulting from the new tariffs should be used to reduce the Federal budget deficit.

S. 1997, sponsored by Senators Wallop and Bentsen, would impose a new excise tax on the first sale or use within the United States of crude oil or refined petroleum products that have been imported. The amount of the excise tax on each barrel of imported crude oil would be equal to the difference between the average world price per barrel of crude oil and a statutorily prescribed floor, set initially at $22 per barrel. The amount of the floor, sometimes referred to as the "survival price" of oil, would be increased annually to account for growth in per capita nominal gross national product. 4/ The average world price of crude oil would be determined quarterly by the Secretary of the Treasury, in consultation with the Secretary of Energy, based on the average per barrel prices for three principal classes of foreign crude oil. 5/

4/ The GNP-adjusted reference price would be rounded off to the next highest dollar. Based on current budget projections, this annual increase would average approximately six percent per year over the fiscal 1986-1991 budget period.

5/ The three classes of foreign crude oil are Rotterdam brent crude, Saudi light, and North Sea forties.

The amount of the excise tax imposed under S. 1997 on each barrel of imported refined petroleum products would be equal to the per barrel excise tax on imported crude oil, increased by a $3 per barrel "environmental outlay adjustment," 6/ multiplied by a barrel of oil equivalent factor. This factor appears to be the ratio of the Btu content of a barrel of refined product to 5.8 million Btu, the content of a barrel of oil. Thus, for example, if the average world oil price were $16 per barrel, the excise tax on a barrel of imported motor gasoline, which yields 5.25 million Btu, would be approximately $8.15. 7/

S. 1997 would exempt from the tax any refined products imported for use as home heating fuel. Unlike S. 1507, however, the bill would not exempt from tax imported crude oil that is imported and refined for use as heating fuel. Further, the bill would provide exemptions for residual fuel oil and for topped crude oil imported for further refining, for "process fuels," and for liquid natural gas. While the scope of the "process fuels" exemption is not clear, it would presumably apply to petroleum products used in certain industrial applications. Finally, S. 1997 would exempt from the new excise tax any crude oil or refined petroleum product that was sold for export within six months following its importation.

Discussion

Although the two bills described above differ in various respects, they share the obvious characteristic of imposing a fee on most imported oil and refined petroleum products, and thus raise a series of common considerations. Except as otherwise indicated, the discussion below applies to both proposals.

We face today crude oil prices that have fallen dramatically. The spot price for West Texas Intermediate crude oil, for example, closed Tuesday at $14.55 per barrel, as compared

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6/ The environmental outlay adjustment would be increased annually to account for per capita GNP growth in the same manner as described above with respect to the statutory floor on the price of oil.

7/ The $8.15 excise tax on a barrel of motor fuel would be computed as follows:

Reference price	$22
World oil price	($16)
Tax on crude oil	$ 6
Environmental Outlay Adjustment	$ 3
Tentative refined product fee	$ 9
"Barrel of oil equivalent" factor (5.25 Btu ÷ 5.8 Btu)	x .905
Motor fuel excise tax	$8.15

to its recent high price of $31.80 per barrel on November 21, 1985. The falling price of crude oil, its effect on the prices of refined petroleum and other sources of energy, and the effect of these price reductions on both the economy in general and on particular regions of the country must obviously influence our consideration of these proposals to impose a fee on imported oil.

Effect on Federal Revenues. As already noted, the Administration would consider the imposition of a fee on imported oil and refined petroleum products only in the context of a revenue-neutral tax reform bill. The President has stated that the House-passed tax reform bill (H.R. 3838) fails in several respects to meet his minimum requirements for an acceptable bill. Many of the improvements suggested by the President, as well as others that have been mentioned by members of the Finance Committee, would entail a significant loss of revenues. Thus, the revenue raised by a tax on imported petroleum could be used to maintain the revenue neutrality of a bill that included the suggested changes. Accordingly, the revenue effects of the proposals being considered by this Subcommittee are an important factor to be considered.

The potential revenue raised by the imposition of a tax on imported oil and refined petroleum products differs depending upon the structure of the proposal. Our analysis shows that the overall revenues (including windfall profit tax collections) raised from a fixed fee or excise tax are not acutely sensitive to the precise level of world oil prices. Thus, a fixed $5 per barrel excise tax would raise roughly the same amount of revenue regardless of whether the world price of crude oil was $20 or $25 per barrel. S. 1507 and S. 1997, however, establish in varying ways an import fee that is explicitly dependent upon the level of world oil prices. Accordingly, the revenue raised by each of these proposals, unlike a fixed fee, would be sensitive to changes in the world oil price.

Assuming an October 1, 1986 effective date and oil prices that remain $4 per barrel below the Administration's latest forecast, 8/ and assuming all other elements of the forecast are

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8/ The latest Administration forecasts, prepared in December 1985, assume that crude oil prices will be as follows:

Year	Price per barrel
1986	$24.76
1987	23.98
1988	23.55
1989	24.07
1990	24.95
1991	25.37

not affected by the imposition of the fee, we estimate that S. 1507, which would impose a $5 per barrel tariff on imported crude oil and a $10 per barrel tariff on imported refined products, would increase revenues by approximately $41.4 billion over the fiscal 1987-1991 budget period. 9/ Because the tariff is phased out as the world price of oil increases from $25 to $30 per barrel and the world price of refined products increases from $25 to $35 per barrel, however, we note that this revenue would not be realized if the current decline in world prices were reversed and prices rose again to their former levels.

35.7

Again assuming that the average world price of crude oil remains $4 per barrel lower than the latest Administration economic forecast, that all other elements of the forecast are not affected by the imposition of the fee, and that the bill becomes effective on October 1, 1986, we estimate that S. 1997 would raise approximately $31.1 billion over the five-year budget period. If the average world price drops more than $4 per barrel below the latest forecast, of course, a greater amount of revenue would be raised annually under S. 1997. 10/

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The provisions of S. 1997 raise even greater uncertainty than S. 1507 in estimating likely revenue effects. In particular, because the rate of tax under S. 1997 depends more directly upon the price of oil, the revenue that it would raise would be even more sensitive to fluctuations in world oil prices than the revenue raised under S. 1507. Given the volatility of oil prices and the influence of foreign governments on these prices, it is difficult to depend upon the taxing mechanism provided in S. 1997 as a stable source of a specified level of revenue over an extended period. Moreover, in a manner similar to S. 1507, the revenue that would be raised by S. 1997 would vanish if the average world price of oil exceeded the adjusted reference price.

35.7 4.5

9/ The $41.4 billion estimated to be raised consists of $36.9 billion in net oil import fees (which reflects a reduction in imports resulting from the fee) and $4.8 billion in additional net windfall profit tax collections. This estimate of the revenue effect of S. 1507 takes into account the exemptions contained in the bill for heating fuel, and oil or refined products used in the manufacture of goods destined for export. If the exemption for home heating fuel were deleted, we estimate an additional revenue increase of $5.7 billion per year. Deletion of the exemption for oil and refined products used to manufacture exports would increase the revenue gain by approximately $1.2 billion. 31.2

26 19.4

10/ The $31.1 billion revenue estimate consists of $24.5 billion in net oil import fees (which reflects a reduction in imports) and $6.6 billion in additional net windfall profit taxes. Our estimate of the revenue effects of S. 1997 reflects our interpretation of each of the exemptions contained in the bill. If the provisions of S. 1997 were applied without the exceptions for products and for petroleum products exported within six months of importation, we estimate that an additional $24.3 billion would be raised during the budget period.

As the foregoing analysis suggests, we must be careful not to assume that the revenue raised by oil import fees of the types proposed in S. 1507 or S. 1997 will always be available to maintain the revenue neutrality of a tax reform bill. Indeed, there is a high degree of uncertainty in predicting the revenue effects of any variable oil import fee. Under today's market conditions, this uncertainty is a major detriment of an oil import fee whose purpose is to ensure that a tax reform bill is revenue neutral.

National Security Considerations. The tax treatment of natural resources has long been important in maintaining a viable domestic energy industry, which is an integral element of our national security. Consequently, the effect that an oil import fee would likely have on the domestic energy industry is a critical factor that must be considered.

There has been a slow, steady decline in world oil prices since 1981. 11/ The domestic oil industry, which includes oil-drilling and well-service contractors, oil tool and pipe manufacturers, and many other businesses, as well as oil producers and refiners, has been forced to adjust gradually to this decline in energy demand, oil prices, and drilling activity. However, the rapidly falling world oil prices encountered recently, if continued, raises the possibility of a greater threat to the strength of the domestic oil industry and will significantly affect the level of exploration and development of our domestic energy resources.

Indeed, several major oil companies recently announced substantial reductions in their domestic exploration and production budgets, and similar announcements from other companies are widely expected. Moreover, if the price of oil continues to fall, many of this country's "stripper wells" (i.e., wells producing on average less than ten barrels of oil each day), which comprise approximately 15 percent of domestic oil production, will be made unprofitable and may be prematurely abandoned.

Because the prices of other sources of energy are related to the price of oil, this reduction in exploration and development may eventually spread to other energy sources such as coal and natural gas. Ultimately, reduced levels of domestic exploratory and developmental activity will lead to reduced domestic production. In the face of both this lower domestic production and greater domestic demand resulting from falling prices, oil imports will increase, leading to greater dependence on foreign oil in the near term.

11/ In 1981, the average domestic oil well-head price was $31.77 per barrel. This price has been declining steadily until 1985, when it reached $23.88 per barrel.

While a greater demand for oil would generally provide pressure for an increase in oil prices, such prices are now significantly affected by the production policies of the major oil-producing nations. Thus, prices might possibly drop to relatively low levels before heightened demand would cause them to increase. Many producers, drilling contractors, and others dependent upon the oil industry might not be able to survive while waiting for the price to rebound.

By imposing taxes solely on imported petroleum, both of the bills being considered by this Subcommittee would generally increase the prices of domestic energy and refined products above the prevailing world prices. Because the prices of all energy sources are to some extent interrelated, the prices of other domestic energy sources would be increased. Thus, the effects to the domestic energy industry that are caused by falling oil prices would be relieved by each proposal. Moreover, the higher price for domestic resources may encourage exploration and development in this country or, at the least, stem the reduction in such activities resulting from lower prices.

General Impact on Business and Industry. The imposition of a tax on imported petroleum would have several clearly delineated effects on non-energy domestic businesses and industries. The increase in energy costs resulting from the tax would obviously have the most serious impact on industries that are heavy energy users or that rely significantly on petroleum feedstocks. In particular, domestic manufacturers of products such as plastic, glass, cement, paper, limestone, steel, textiles, aluminum, chemicals, and paint would face substantially higher costs. The agriculture sector, particularly farmers, also would be especially hurt, because the likely decrease in the costs of fuel and fertilizer resulting from falling world oil prices would be partially or fully offset by the imposition of an oil import fee.

In addition to the direct impact that higher energy costs would have on most domestic industries, an oil import fee also would make it more difficult for many domestic industries to sell their products abroad. Exports from the United States would face tougher competition because foreign producers of comparable goods would benefit from falling energy costs at the same time that the import fee would be maintaining U.S. energy prices at a relatively higher level. Indeed, many of the industries that would be most affected by higher energy costs have previously complained about the relatively low energy costs enjoyed by some foreign competitors. Moreover, the impact of an oil import fee on the international competitiveness of many industries would be exacerbated by an increase in imports of energy-intensive manufactured products, which would continue to enjoy the benefit of lower foreign energy costs.

Each of the effects described above would offset the reduced imports of foreign crude oil and refined products that would result from imposition of an import fee. Accordingly, imposition of an oil import fee ultimately could negatively affect our balance of trade.

Even if an exemption from the tax were provided for crude oil or refined petroleum products imported to manufacture goods destined for export, as contemplated in varying degree by S. 1507 and S. 1997, it is likely that the relief would be effective in only a limited number of cases, and that the international competitiveness of many industries would, nevertheless, be negatively affected by an oil import fee. In particular, an exemption would probably effectively benefit only vertically integrated producers that directly import petroleum for use in the manufacture of exports. The benefit of such an exemption would be of limited effectiveness, at best, for the many independent producers of intermediate and final products. Finally, imposition of an oil import fee would likely hurt independent marketers of petroleum, who cannot rely on increased production income to offset the reduced demand for their products that an oil import fee would likely entail.

Although the effects of an oil import fee on domestic industry would in general be negative, such a fee would aid several energy-producing areas. As discussed in the context of national security, imposition of an import fee would significantly benefit certain sectors of the domestic energy industry. An oil import fee also could have a major effect on the domestic refining industry. Due largely to declines in U.S. petroleum consumption and decontrol of oil prices, we have faced recently a reduction in U.S. operating refining capacity. 12/ Although domestic refiners, like all purchasers of oil, would face the higher energy costs resulting from an oil import fee, they would benefit from a structure that imposes a higher fee on refined products than on crude oil and thus discourages the importation of refined products. In this regard, it should be noted that S. 1507 and S. 1997 in different respects would both establish a higher fee on imported refined products than on imported crude oil. Accordingly, both of those proposals would aid domestic refiners.

In addition, we recognize that oil royalties, severance taxes, and other energy-related receipts are a significant source of revenue for some States. Consequently, the fiscal health of these States, which has been hurt by the steep decline in oil prices, would be improved through imposition of an oil import fee. Rapidly falling oil prices also may have an adverse impact

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12/ Data compiled by the Energy Information Administration indicate that U.S. operable refinery capacity has declined from 18.62 million barrels per year on January 1, 1981, to 15.7 million barrels on January 1, 1985. This capacity did not decline further during 1985.

on banks that have made energy loans. Many of these banks have recently made provisions for additional loan loss reserves and have reduced their volume of new energy loans. Nevertheless, continued instability in oil prices may have more serious effects on such banks, and could trigger some bank failures. By softening the fall of domestic energy prices, an oil import fee would protect those banks from declines in market prices. This beneficial effect may be offset, however, because other banks may be helped by falling oil prices and certain banks with loans to oil-exporting nations may be hurt by imposition of an oil import fee.

Effects on Energy Consumption. Higher energy costs have encouraged greater energy conservation. Some of these conservation efforts have resulted in the development of more fuel-efficient cars and appliances, and the design and installation of more energy-efficient industrial facilities. While these developments are likely to represent more permanent changes, a number of other conservation efforts, such as the installation of greater insulation in older homes and the willingness to tolerate lower winter or higher summer temperatures by adjusting thermostats, may well be dissipated by a drop in energy costs.

Policies that raise the prices of energy for consumers, such as an oil import fee, would encourage the continuation of these efforts and would deter energy use. This would be a step toward further reducing our reliance on uncertain foreign supplies.

Effect on Consumers. It is extremely difficult to determine precisely how higher energy costs resulting from a tax on imported petroleum would be distributed throughout the economy. To some extent, these costs would be shared by foreign oil producers and refiners, domestic businesses that use energy, and consumers. While tracing the precise incidence of these costs is difficult, consumers would clearly be directly and adversely affected by higher energy prices through purchases of gasoline and, depending upon the scope and effectiveness of any exemptions, home heating oil and electricity generated by burning residual fuel oil. Moreover, because prices for almost all sources of energy are interrelated and depend to a great extent on the prevailing price of oil, consumers would face increased costs through purchases of other sources of energy, including natural gas and, to a lesser extent, electricity generated by burning coal or natural gas. In addition, consumers would indirectly bear higher costs in their purchases of all goods and services, because the higher energy costs that would be faced by producers of energy-intensive basic materials and by the construction and transportation industries would, in turn, be reflected in higher prices generally.

While the effects described above would occur in the case of most consumption-based taxes, their nature is altered in the case of an oil import fee, because the Treasury would realize an increase in revenue only with respect to oil imports, while consumers would bear higher prices on all petroleum products and natural gas (and other goods), regardless of whether the oil, natural gas, or refined product was produced in the United States or abroad. Thus, while the burden of the tax would fall upon foreign producers and domestic consumers, the benefits would be shared by the Federal government and the domestic oil industry. In general, our analysis indicates that, based solely on the increase in oil prices, the domestic oil industry would realize after-tax benefits equal to $1.75 for every $1 of tax collected by the Treasury. 13/ To the extent that higher oil prices also lead to higher prices for natural gas and coal, the energy industry would realize an even greater share of the benefit in proportion to Federal revenue.

Distributional Impact. The Administration has proposed that, to the greatest extent possible, the distribution by income class of taxes paid should generally be the same following tax reform as under current law. Moreover, we have proposed that the tax system should not be an additional burden on those below the poverty line, and that such poor families should, insofar as possible, totally escape Federal income taxation. We also have sought to reduce the tax burden on middle-income working Americans. Accordingly, we must carefully evaluate the distributional impact of an oil import fee when considering the advisability of such a tax.

Lower income families spend a relatively large portion of their income on energy consumption. Families with incomes below $12,000, for example, spend approximately 25 percent of their

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13/ The allocation of the benefits of an oil import fee could be partially shifted away from domestic producers by enactment of an alternative windfall profit tax. Such a tax, which would apply to domestic oil, would withhold from the oil industry a portion of the increase in the price of domestic oil that would result from an import fee, by assuring that all oil producers would pay some excise tax with respect to the increased price of oil, and would thus shift more of the benefit to the Federal government. An alternative windfall tax also would permit the import fee to be set at lower rates, and still raise the same aggregate revenue. An alternative windfall profit tax equal to 50 percent of the oil import fee, for example, would provide an approximately equal split of the benefit between the Federal government and the domestic oil industry.

incomes on gasoline, fuel, and other energy uses, while families with incomes above $42,000 spend less than seven percent of their incomes on such expenditures. Consequently, any energy tax tends to be regressive in effect, taking a relatively greater share of income from the poor and middle class. The higher energy costs resulting from energy taxes also may lead to higher prices for other consumer goods, thus intensifying this burden on the poor and middle class, although possibly reducing slightly the regressive effect of such taxes.

The distributional impact of oil import fees, depending upon the scope and effectiveness of any exemptions, can be extremely regressive. As detailed in Table 1, for example, we estimate that the $5 and $10 per barrel tariffs imposed by S. 1507, ignoring the exemption provided for home heating fuel, would in 1989 increase energy costs for families with incomes below $10,000 by an average of 2.47 percent of total income. In contrast, the energy costs for families with incomes above $100,000 would increase by an average of only 0.20 percent of total income. When the exemption provided by S. 1507 for home heating fuel is considered, the regressive effect of the tax is curtailed, but the energy costs paid by lower income families would still increase by an average of 1.92 percent of income, while the energy costs of the higher income families would increase by only 0.18 percent. Perhaps more significantly, the increased burden of energy costs resulting from imposition of an oil import fee, as set forth in the Table 1, would for most families more than offset the tax decreases that are provided in the President's tax reform proposals. The impact of S. 1997, as illustrated in Table 2, is also regressive.

The regressive nature of a tax on imported oil and refined products may be corrected through several possible means in addition to the varying exemptions for home heating fuel proposed by the bills. First, the income tax rate schedules could be modified to reduce the taxes paid by those in the income classes that are most seriously hurt by the oil import fee. This solution, however, would substantially reduce aggregate income tax revenues, thus making enactment of a revenue-neutral tax reform bill more difficult. Moreover, an adjustment to the rate schedules would not help many of the families that are most negatively affected by an oil import fee, namely those who already do not face any income tax liability and those who will be removed from the tax rolls by virtue of tax reform.

Second, consideration could be given to targeting relief narrowly to the additional burden faced by lower income families. In particular, imposition of an oil import fee could be accompanied by enactment of a refundable income tax credit directed at lower income families. Although a refundable credit might be difficult to design satisfactorily and would undoubtedly pose substantial administrative problems, such a credit could be used to reduce the regressive nature of an energy tax at a relatively moderate revenue cost.

Regional Impact. An oil import fee would have a disproportionate impact on certain regions of the United States that consume more energy or different types of energy than other areas. As illustrated by Table 3, the consumption of energy varies significantly by region. Families in the Northeast, for example, consume more energy than do families in other regions. In addition, because the various regions differ in population density and availability of public transportation, they also differ in their use of motor fuels. For example, gasoline consumption is regionally dependent, and tends to be higher in areas outside the Northeast. Finally, the types of fuels used in different regions vary, and those differences contribute to a non-uniform regional impact of an oil import fee.

As suggested by the levels of energy expenditures set forth in Table 3, the burden of an oil import fee, imposed without any exception, would be felt most heavily in the Northeast. Both proposals being considered by the Subcommittee mitigate this disproportionate regional impact by providing exemptions for heating fuel and, in the case of S. 1507, crude oil, that is to be refined into home heating fuel. This solution, while in concept a well-intentioned response, raises several concerns.

Exemptions for petroleum used for specific purposes are difficult to administer effectively, will impose bureaucratic burdens on segments of the domestic oil industry, and may offer only limited relief to the affected people. For example, if an exemption were granted only to home heating fuel, as proposed by S. 1997, a powerful incentive would be created to increase imports of home heating fuel, thus hurting domestic refineries. If this effect were avoided by extending the exemption to crude oil imported for use in refining home heating fuel, as proposed by S. 1507, the exemption would be more effective in shielding the cost of home heating oil from a price increase. The potential revenue increase resulting from imposition of the import fee, however, would be reduced considerably. In particular, we estimate that an exemption granted to both crude oil and refined home heating fuel, such as the one proposed by S. 1507, would reduce the revenue gained through an import fee by approximately 15 percent.

More significantly, however, the task of monitoring the ultimate use of refined products produced from imported crude oil would be extremely onerous. Such a task is particularly difficult, because home heating fuel is used for commercial heating and also is virtually identical to diesel fuel, uses that would not enjoy any special exemptions under either bill. Finally, we should not underestimate the potential bureaucratic and regulatory burdens that the administration of such exemptions might place on domestic producers, refiners, and heating oil distributors.

The burden of increased residential electric bills, caused by the higher costs of residual fuel oil and natural gas used to generate electricity, that would result from an oil import fee also falls disproportionately on the Northeast. Similarly, natural gas prices would increase sympathetically with higher oil prices. The increased cost of heating homes with electricity or natural gas, however, is not addressed in either bill. In addition, California would be especially affected by such a fee, because of its dependence upon oil-generated electricity. A scheme of exemptions for residual fuel designed to correct this impact would lead to greater revenue losses and more administrative problems and bureaucratic burdens than would be created by an exemption for home heating fuel.

Foreign Policy Considerations. Any proposal to impose a fee on imported crude oil and refined petroleum products raises a host of foreign policy concerns. As discussed below, the imposition of an oil import fee, depending upon its provisions, would raise concerns under the General Agreement on Tariffs and Trade (GATT) and bilateral agreements with several oil-exporting countries. In addition, an import fee, by increasing the price of imported oil and refined petroleum products, would decrease U.S. demand for such oil, and would thus reduce the volume of exports for many countries, some of which are heavily dependent upon revenues from such sales to meet foreign loan obligations. While the effects of such a decrease would vary depending upon the country, it would especially hurt several of our most established trading partners, including Mexico, Canada, Venezuela, and the United Kingdom, each of which supplies a significant portion of our petroleum imports. While exemptions for oil imported from one or more particular countries could be provided to mitigate these consequences, such exemptions would not only raise the treaty concerns discussed below, but also would pose even greater administrative and bureaucratic burdens than an exemption for home heating fuel or other specific uses. Moreover, such exemptions, depending upon the countries involved, could significantly affect the potential revenue raised by an oil import fee. 14/

Administrative Burdens. As noted above, we are concerned that the proposals for various exemptions contained in both bills would lead to substantial administrative and bureaucratic burdens. In particular, providing exemptions for crude oil or refined products imported from particular countries or for particular uses might necessitate an extensive regulatory and enforcement apparatus. Such regulation could amount to unreasonable Federal government intrusion into the oil business, a role we properly abandoned with the removal of oil price controls in 1981.

14/ Based on current import levels, if an exemption were provided for crude oil and refined petroleum products imported from Mexico, we estimate a 17 percent reduction in the revenue potentially raised by any of the proposals. If exemptions were provided for Canada, Venezuela, or the United Kingdom, we estimate that the revenue would be decreased by 15 percent, 12 percent, and six percent, respectively. Moreover, we note that granting an unlimited exemption for oil imported from certain countries may result in an increase in imports from those countries, thereby magnifying the potential reductions in revenues.

Effect of GATT and Other Treaty Issues. We are reviewing whether the various oil import fee proposals are consistent with our treaty obligations under the General Agreement on Tariffs and Trade (the "GATT") and various other bilateral agreements. We have committed ourselves in the GATT not to increase our tariffs on refined petroleum products. 15/ Both of the oil import fees under consideration would violate these commitments unless one of the GATT exceptions applies. One such exception is national security. We are considering whether, under current conditions, an import fee can be justified as necessary, in GATT terms, for the protection of "essential security interests."

The GATT generally allows other countries to "redress the balance of concessions" if one country imposes new import barriers, even if those restrictions are permissible under the GATT exceptions. If GATT signatories harmed by the oil import fee were to redress the balance of concessions by imposing offsetting duties on U.S. products, this would harm U.S. producers of such products. One way to avoid other countries redressing the balance by retaliation would be to offer them "compensation" by reducing U.S. trade barriers to other products such countries export to the United States. However, providing compensation by reducing U.S. trade barriers to other products from injured countries would adversely affect U.S. producers of competing products. Compensation would also reduce the net revenue raised from any oil import fee.

If the import fee were applied on a discriminatory basis, such as exempting certain suppliers, it would also violate the non-discrimination obligation in the GATT generally known as the most favored nation provision. Various bilateral Friendship, Commerce and Navigation Treaties, including treaties with some oil producing countries that are not GATT signatories, contain similar most favored nation provisions. Excepting some suppliers from any oil import fee would be likely to draw a response from those suppliers entitled to most favored nation treatment that are not excepted. Before deciding on any oil import fee, we should carefully consider U.S. treaty obligations and the adverse effect any breach of such obligations would have on U.S. producers.

15/ We have made a similar commitment to Venezuela with respect to crude oil in a bilateral treaty. The most favored nation provision in the GATT, discussed below, would preclude the United States from imposing higher duties on GATT signatories than on Venezuela.

Macroeconomic Effects. As an oil-importing nation, the United States stands to benefit from the decline in world oil prices. The present decline, if sustained, will likely result in a short-term reduction in the inflation rate and a longer-term reduction in interest rates. The decline in world oil prices is expected to result directly in lower prices for both refined oil products and other fuels. In addition, the cost of many energy-intensive goods, ranging from steel and other metals to glass, ceramic, and plastic products, also would be expected to decline. These macroeconomic benefits resulting from lower oil prices would be diluted if an oil import fee were imposed.

An oil import fee would clearly affect the relative price of goods and services, but the extent of its impact on the overall price level and interest rates would depend, in part, on the response of the Federal Reserve. If the money supply were allowed to increase to accommodate the fee, there would be a short-term increase in the inflation rate, thus offsetting the price reductions that would otherwise result from lower world oil prices. 16/ If the money supply were held steady, however, there would likely be a reduction in labor and capital income. In short, depending upon monetary policy, one might expect either higher prices and a slight decline in real GNP or more stable prices and greater decline in real GNP.

Conclusion

As I have indicated throughout my testimony, there are both benefits and detriments that would result from the imposition of an oil import fee as proposed in S. 1507 and S. 1997. The President has stated that he would not foreclose consideration of an oil import fee in the context of a revenue-neutral tax reform bill that meets his prerequisites.

16/ In addition to its more general effects, the inflationary impact of the oil import fee, if any, might also lead to increased Federal outlays for various entitlement programs that are affected by the Consumer Price Index (CPI) and for interest payments on the national debt. Although it is difficult to determine the precise impact that an oil import fee would have on the CPI, we note that a reduction in the CPI of one percentage point could result in a $4 billion saving in Federal outlays.

Table 1

Average Per-Family Burden for The Boren-Bentsen Bill (S. 1507), for 1989, Assuming Oil Prices $4 per barrel less than CEA Projections.

Family Income ($ thousands)	Increase in Oil Expenditures (in dollars) 1/				Increase in Expenditures as Percent of Family Income 2/	
	Electricity	Fuel Oil&LPG	Gasoline	Total	No Exemptions	As proposed
0-10	6.56	27.72	89.33	123.62	2.47	1.92
10-15	8.89	28.13	129.62	166.64	1.33	1.11
15-20	9.81	23.36	154.19	187.37	1.07	.94
20-30	10.53	25.61	186.58	222.72	.89	.79
30-50	14.30	32.35	241.95	288.60	.72	.64
50-100	19.06	39.53	309.45	368.04	.49	.44
100 or more	27.11	59.23	319.51	400.85	.20	.18
U.S. Average	12.23	35.10	196.49	287.77		

Family Income ($ thou.)	Percentage Change in Tax Under President's Proposal	Increase in Expenditures as % of Current Tax		Total % Change In Tax Burden	
		No Exempt.	As proposed	No Exempt.	As Proposed
0-10	-35.5	177.6	137.0	141.1	101.5
10-15	-22.8	41.7	34.6	18.9	11.8
15-20	-13.5	23.3	20.4	9.8	6.9
20-30	-8.7	14.4	12.5	5.4	3.8
30-50	-6.6	9.3	8.2	2.7	1.6
50-100	-4.2	5.2	4.7	1.0	.5
100 or more	-5.3	1.5	1.4	-3.8	-3.9

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1/ Assumes that foreign and domestic producers absorb $1 per barrel of the fee. Does not include increased price of natural gas or non-oil goods.

2/ Does not include possible increase in transfer payments.

Table 2

Average Per-Family Burden for the Wallop-Bentsen Bill (S. 1997),
for 1989, Assuming Oil Prices $4 per barrel less than CEA Projections.

Family Income ($ thousands)	Increase in Oil Expenditures (in dollars) 1/				Increase in Expenditures as Percent of Family Income 2/	
	Electricity	Fuel Oil&LPG	Gasoline	Total	No Exemptions	As proposed
0-10	9.84	41.59	134.00	185.43	3.71	2.88
10-15	13.34	42.19	194.44	249.96	2.00	1.66
115-20	14.72	35.04	231.29	281.05	1.61	1.41
20-30	15.80	38.41	279.87	334.09	1.34	1.18
30-50	21.44	48.52	362.93	432.90	1.08	.96
50-100	28.58	59.29	464.18	552.06	.74	.66
100 or more	40.67	81.34	479.26	601.26	.30	.26
U.S. Average	18.35	52.64	294.29	365.27		

Family Income ($ thou.)	Percentage Change in Tax Under President's Proposal	Import Fee Burden as % of Current Tax		Total % Change In Tax Burden	
		No Exempt.	As proposed	No Exempt.	As Proposed
0-10	-35.5	264.9	205.5	229.[illegible]	170.0
10-15	-22.8	62.5	51.9	39.7	29.1
15-20	-13.5	34.9	30.6	21.4	17.1
20-30	-8.7	21.2	18.8	12.5	10.1
30-50	-6.6	13.9	12.3	7.3	5.7
50-100	-4.2	7.8	7.0	3.6	2.8
100 or more	-5.3	2.3	2.0	-3.0	-3.3

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1/ Assumes that foreign and domestic producers absorb $1 per barrel of the fee. Does not include increased price of natural gas or non-oil goods.

2/ Does not include possible increase in transfer payments.

Table 3

Per-Family 1983 Household Energy Expenditures by Region (in dollars).

Region	Natural Gas	Electricity	Fuel Oil, LPG	Gasoline	Total
Northeast	400.00	577.78	388.89	972.22	2,338.89
Midwest	431.92	525.82	103.29	1,126.76	2,187.79
South	224.20	697.51	92.53	1,209.96	2,224.20
West	260.61	430.30	42.42	1,181.82	1,915.15
Average U.S.	323.78	578.26	146.95	1,136.20	2,185.19

Source: Energy Information Administration

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Senator Wallop. Would it be fair to characterize the administration's position as sitting on the fence with both ears to the ground? [Laughter.]

Mr. Mentz. That would be one way of characterizing it. I would prefer to think of it as a position of not foreclosing a fee or a tax. The world may change significantly between now and the time we are almost finished markup and certainly by the time we are in conference. And as our experience in the House proves, it can be very difficult to get a tax reform bill together that meets the generally stated objectives of reducing the cost of capital, reducing the marginal effective tax rates, marginal tax rates, increasing the personal exemption at least for the lower and middle income families and getting 6 million people off the tax rolls. And to the extent that we run into problems in that situation, Mr. Chairman, we would like to see it still on the table.

If that is straddling the issue, I guess I stand convicted.

Senator Wallop. Let me just make an observation from my own personal standpoint.

Mr. Mentz. Sure.

Senator Wallop. That position epitomizes all the wrong perspective. It has nothing to do with energy policy and has only to do with the convenience of a tax policy. And for all the reasons that were mentioned negatively in your statement, should not be considered for reasons of tax reform.

But I am going to keep those observations now to myself.

I am going to ask my colleagues to suspend whatever questions we have of these witnesses until 11 in order to get to the testimony of Alan Greenspan. If there are other questions that you would wish to ask them after that, I will ask them to remain. But I would like to hear his testimony and have the committee have an opportunity to question him before he has an airplane that he must catch at 11:25.

Senator Bentsen.

Senator Bentsen. Thank you very much, Mr. Chairman.

Secretary Mentz, I would characterize your testimony as, "on the other hand." What we really need is a good one-armed witness representing the administration. It would give up a much more useful point of view.

Secretary Boggs, I am concerned about the reversal in policy by the administration regarding energy conservation in this country. It seems to me we are headed in the wrong direction. It seems to me we are playing right into the hands of OPEC. Consumption has risen on gasoline in this country in the last 2 or 3 years. And it is going to soar when you see the price of gasoline go down further. The band is going to explode.

And yet the gasoline mileage guide that has been put out by the Department of Energy, the bible for consumers seeking fuel efficient automobiles has been killed. Your agency has been putting it out for years, yet you took the $900,000 out of the budget needed to produce it.

Another example is the manufacturer's average fuel economy standard for passenger cars. It was 27½ miles per gallon in 1985. That was set by Congress in the Energy Policy and Conservation Act of 1975. Yet last winter, the Department of Transportation reduced the standard for 1986 to 26 miles per gallon from 27½ miles per gallon in 1985.

Hearings were held on Tuesday to lower them again. And I heard the chairman say that the GSA put out a regulation yesterday saying that public buildings could lower the thermostats in the summer, and they could raise the thermostats in the winter.

What kind of an energy policy in the way of conservation are we pursuing? It seems that we are playing right into the hands of OPEC.

Would you respond to that?

Secretary **Boggs**. Well, Senator, I think the first thing I would say is that the question is how much does it cost for each unit of conservation. We clearly can reduce use by imposing various rules and telling people you just can't use energy, go do something else.

We have tended, I think, to find that those are not the best way to run an economy. You made a whole series of different statements which I will try to address.

Senator **Bentsen**. A series of things that you have done in your Department.

Secretary **Boggs**. Which I would try to reply to individually.

The CAFE standards are not our Department. They are Transportation. But, certainly, I would say two things. First, there have been a number of analyses including Robert Crandall of the Brookings Institution, which is not normally a great supporter of the Reagan administration, arguing that the CAFE standards by themselves had no effect. It was the prices that have driven it all along. And the question is: In order to get a certain reduction in consumption, what kind of a burden do you want to impose upon people? Do you want to tell them they can't have a car that is as comfortable as they want? They can't have a car that is big enough for their family? They cannot do things in that one area when you do not do it in any other area? People can fly private jets. People can use energy in all kinds of other areas. But we put a burden on one particular area. That is why we think that those kind of things in general are not particularly good ideas.

I think it is important to look at the result in the entire economy. Prices have come down since 1980, consumption of energy relative to GNP has continued to come down. This past year, our total use of energy was essentially flat. Our total use of oil was essentially flat. And our GNP, our real GNP, went up another 2 to 2½ percent.

Now I cannot deny, Senator, that the lower prices go, the more energy people will use relative to other inputs. But the point is: Is Congress or is the Department of Energy sufficiently smart to pick exactly the way that they should use it? Is it wasteful for people to use a dollar's worth of energy rather than 2 dollars' worth of steel or 2 dollars' worth of labor or 2 dollars' worth of something else?

In general, we don't believe so.

Senator **Bentsen**. Mr. Secretary, I believe that if we had not put on the requirements we did on American automobile manufacturers, the Japanese would have totally taken over this market. American people, I think, wanted cars that gave them better gasoline mileage.

Thank you very much.

Senator Wallop. Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman.

Mr. Mentz, I thought you had some excellent points in your statement.

Senator Wallop. That is the one hand. [Laughter.]

Mr. Mentz. Something for everyone, Senator.

Senator Chafee. Well, I just looked at the things that I found acceptable and savored them. So we appreciate your coming here.

I just want to ask you one question, and it deals with what you have in your front page. It deals with tax reform, and the new form of tax such as this.

What is the sense of having tax reform which is designed to reduce the marginal rates for individuals and corporations and to eliminate preferences, exemptions, credits, deductions—that was the objective, and now you are throwing a new element into the equation. It is perfectly all right to get the lower rates, but do not get them through the elimination of these credits and exemptions and so forth, but to do it by new taxes.

To me, that does not make any sense whatsoever. Am I missing something?

Mr. Mentz. Well, no, you are not. I do not believe I said it was perfectly all right. I straddled a little better than that, I think.

I believe what I meant to reflect, Senator Chafee, was the administration's position is that just that these proposals or perhaps a variation of them—maybe you would need a proposal with a little more stable revenue source—should at least not be totally put off the table until we get into tax reform. I agree with you that there are complexities that would be introduced by an oil import fee—particularly, the design features that would be necessary to make it not regressive—that would be necessary to take into account the problems of the Northeast, the energy-related export problem, the petrochemical problem.

There are a lot of design problems in this concept. And maybe when the day is over, Senator, those will be so insuperable as to make it not doable.

But I don't want to rule it out at this point.

Senator Chafee. I am not for the oil import fee, period, in case anybody is not familiar with my position.

But to even mention additional taxes, whether it is a gasoline tax or anything like that, in connection with tax reform, I think is just leading us down a path here in which we will completely avoid making the difficult decisions we were meant to make in tax reform. Why eliminate preference A, B, or C if you can make it up by a new tax?

Mr. Mentz. Well, I agree with you that it is far better to maintain the discipline of dealing with tax reform within the confines of the income tax system. That is what the President's proposals did. And I think that is the preferred way of approaching it.

And, as I said in my opening remarks, if you can do that, if we can do it—and I hope to be a part of the process, Senator—God bless us all. But if we have problems doing it, I think we may have to look for revenue sources, and perhaps this is one.

Senator Chafee. Well, I think that is a mistake to even suggest that. And, finally, I would like to stress to everybody here the remarks you make on page 8 of your testimony in which you are not talking just about the northeast. Certainly, the Northeast is penalized in heating costs, and the Northeast is penalized in the fact that our electricity to a considerable degree is generated by oil.

But look in the middle of page 8: "The general impact on business and industry." This legislation may help some banks or the oil industry but look at the difficulties it is going to cause to other industries—limestone, steel, textiles, which is being buffeted from hither to yon already. To suggest that they take a further blow is bad business. Glass, cement, chemicals, and the farmers. The farmers are reeling now.

So that I want to stress that particular point that I think you made so well in your testimony.

Thank you.

Mr. MENTZ. Thank you, Senator.

Senator WALLOP. Senator Boren.

Senator BOREN. Thank you, Mr. Chairman.

I would just like to ask this question: We know that lifting costs, as I mentioned, in this country are somewhere in the low range of $12 a barrel on the low end, and they go up as high as $18 a barrel with stripper production of 10 barrels per day or less. Now do you think that we can sustain—you talked about the great gains we have made in domestic energy production and reducing our imports to all time-low levels. By 1985, we had really made substantial progress along these lines, and I think it is due to some of the steps that have been taken in terms of reducing the regulatory burdens and others. How long do you think that we can keep the price of oil below the lifting cost? In other words, we would call it predatory pricing if we were talking about an antitrust action if someone came in and deliberately lowered the price of a product below its cost of production and kept it there long enough to put their competitor out of business. We would call that predatory pricing.

How long do you think it will be, how long can we stay at this level? Has the administration made any estimate of how long we can stay with prices at or below the cost of production before we severely curtail the production in this country?

How long would it be, for example, before we are back up to 50 percent dependence on imports of oil if the price stayed in the $15 range? Do you have any estimate of when that would occur?

Secretary BOGGS. Well, first, let me say that we have always been very reluctant based on past history to put a great deal of faith in particular model-derived estimates. In particular, I would point out that the production and the consumption that we have now are far more favorable than were projected on much higher prices in the past. So anything that I say has to be, I think, very clearly qualified by that.

The second point I would make is that there is not a single price of production. There is not a single cost of production. Many wells shut down every year because it turned out that their lifting cost was higher than the price then back when it was $30, $35, and $40.

Senator BOREN. Let me interrupt you then so I can get an answer for the question, please.

If the price of oil were to go to $10 a barrel, they might just as well decide, Saudi Arabia, tomorrow to drive it to that price so they put Mexico and Nigeria and others on their knees begging. If it were to go to $10 a barrel, I think you would agree. No one has the cost of production in this country, virtually no one—it would be an infinitestimal percentage at $10 or lower lifting cost. No one has a lifting cost that low.

Secretary Boggs. I would disagree with that, Senator.

Senator Boren. Tell me then who, where, how much, what percentage

Secretary Boggs. Well, if the price of oil in this country——

Senator Boren. What is the bottom price of production in this country?

Secretary Boggs. There are a lot of places that are much lower than that. The question is: At $10 a barrel, production will be lower than at $15, which will be lower than at $20. I could try to get you a specific study which would be a lot better than something off the top of my head. But I say that at $10 a barrel I don't believe that U.S. production would be zero. I don't believe it would be 1 million barrels a day. I don't believe it would be 2 million barrels a day. I believe it would be a good bit higher than that.

Senator Boren. Well, if it stayed at $10 a barrel, let us say, for 2 years, do you think—at what point do you think we would cross the 50-percent point in imports?

Secretary Boggs. My personal belief, Senator—and I am not speaking based on—I don't have a big study at my fingertips. We may be able to get one. I am not sure that I would believe them. But my personal belief would be that if the price went to $10 a barrel and it stayed there, it would still be a good number of years, say 5 to 10 years, before we got to 50 percent.

Senator Boren. Well, I hope you are not advising the President on this matter. That is all I can say.

Let me ask you this point. Maybe I can get a yes or no. Is it in the interest of our national security to allow the price of a strategic commodity—now do you agree that oil is a strategic commodity? Maybe we can get an agreement on that. For national security reasons, is it a strategic commodity?

Secretary Boggs. It is a very important commodity.

Senator Boren. Is it a strategic commodity, strategically important commodity?

Secretary Boggs. Let us not fence as to what you would mean. It is very important, yes.

Senator Boren. Well, let me direct this question to Mr. Mentz. We can't even communicate if you do not think oil is a strategic commodity.

Secretary Boggs. Let us say it is strategic, then. I would appreciate hearing the question.

Senator Boren. All right, strategic commodity. Do you think it is in the national interest of this country to allow the price of a strategic commodity for this country to be artificially kept below its average cost of production in this country for a prolonged period of time? Do you think that we can allow it to be kept below its cost of production for a rather lengthy period of time without it damaging our national security? I would like just a yes or no. Can we keep the price, the cost, of a strategic commodity to this country kept artificially below its cost of production in this country for a prolonged period of time without it damaging our national security?

Secretary Boggs. There are a number of assumptions in that. I am not sure that it is happening artificially. But let me say that if the outcome of that question is how high do we want to prevent imports from being——

Senator Boren. I just want a yes or no.

Secretary Boggs. And how much are we willing to pay for it.

Senator Boren. Well, let me address my question to Mr. Mentz. I am getting nothing but double-talk here. Can you—now this is a very simple question. My God, if we can't answer this question, you cannot answer anything. You do not have any concept of what national security is.

Can we afford to artificially have the cost of a commodity that is vital to this national security kept below its cost of production for a prolonged period of time without damaging the national security of this country? Can we? Whether it is $4 a barrel or $10 a barrel?

Mr. Mentz. Senator, I would love to answer you, but I am not competent to do so. That is for the gentleman on my right. [Laughter.]

Senator Wallop. Congressional hearings are a thrill a minute. [Laughter.]

Senator Boren. All I can say is I am astonished. I am certainly not gratified. Again, to go back to what I said about——

Senator Wallop. There was an old saying of Confucius, Mr. Boggs: "But cautious seldom err." I think perhaps you have not erred in the response that you did not give, but it would have been gratifying to hear one.

Senator Mitchell.

Senator Mitchell. Thank you, Mr. Chairman.

Mr. Mentz, last year during House deliberations on the tax bill, Secretary Baker said that one place the President was going to draw the line in the sand was reducing the marginal rates, getting the maximum rate, down to 35 percent. The President has said himself many times that is his highest priority. And at the retreat we had last month, it was reiterated. We have got to get the maximum rate down to 35 percent.

According to information from the Treasury Department, that somewhere less than 15 percent of American taxpayers have incomes at a sufficient level to pay at that rate. About 8 percent pay marginal rates in excess of 38 percent, and somewhere between 10 and 15 percent pay at the 35 or higher marginal rate.

Now you have come here and said that the President would consider the imposition of a fee on imported oil only in the context of a revenue neutral tax reform bill. Your own testimony, the tables attached to your testimony, indicate that the effect of an oil import fee would be disproportionately much higher on lower income families than higher incomes. According to the tables on your testimony, the bill introduced by Senator Wallop would result in a 170-percent increase in the tax burden on families with incomes below $10,000. Senator Boren's bill would increase the tax burden on those families less than $10,000 by 100 percent.

Meanwhile, those two bills would actually reduce the tax burdens on those families with incomes in excess of $100,000, a 3-percent reduction in one case and a 4-percent reduction in another.

So now what you have done is come in here and say that we want to reduce the maximum rate from 50 to 35 percent, which at most benefits 10 to 15 percent of the highest income persons in our society. And you will accept as a way to pay for it an oil import fee, which according to your own testimony impacts most severely on the bottom end of our society with dramatic increases in the tax burdens for the very poorest persons in our society.

This is not an abstract notion in my State, Mr. Mentz. According to recent economic figures from the University of Maine, 60 percent of households in Maine have incomes of less than $10,000 a year, and we have some of the highest home heating oil costs in the country.

How can you conceivably justify supporting an oil import fee in the context of tax reform; not only as a matter of tax policy, but as a matter of simple fairness? Indeed, I think it is immoral to suggest that we are going to finance reducing the tax rates for the wealthiest 10 or 12 percent of persons in our society by imposing an enormous tax burden on the very poorest persons in our society.

How can you justify that, Mr. Mentz?

Mr. MENTZ. Well, Senator Mitchell, I guess I was unable to communicate my point to you on the distributional aspects of the oil import fee. I do not justify it. And, indeed, these distribution results are so unacceptable that without some remedy there is no way that the President would accept them as part of a tax reform package. Nor would any Senator or any Congressman, in my judgment, vote for that kind of a distribution.

Senator MITCHELL. But you said that, Mr. Mentz.

Mr. MENTZ. No; I did not. No; I did not.

Senator MITCHELL. You said—and I am quoting from your statement: "The administration would consider the imposition of a fee on imported oil and refined petroleum products only in the context of a revenue neutral tax reform bill." You have also said and you have acknowledged many times; you, the President, and Secretary Baker, that your highest priority is to reduce the maximum marginal tax rate from 50 to 35 percent, which you acknowledge benefits only the very top of the income levels in our society.

Mr. MENTZ. Well, first of all, let us get clear what the administration's priorities are on distribution. The distribution of tax relief to individuals is a key element of the President's proposals. It was important in the Ways and Means bill, and it is going to be very important in what the Senate Finance Committee does.

There is no way that the administration would accept a bill that had a distributional pattern anywhere near what is reflected in those tables.

The point that I am making and perhaps not making effectively, Senator, is that without modification, without a targeting of relief to lower income taxpayers so that you have a distribution pattern along the lines of that contained in the table—if I can find it——

Senator MITCHELL. Well, I know what that table says.

Mr. MENTZ. In table 1, column on the left, before taking into account the oil import fee, unless we can show a distribution pattern along that line, it would be unacceptable to the President. That is why I said while the administration believes this proposal should not be taken off the table, it is acceptable only if within the confines of fundamental tax reform it fits all of the important criteria, one of which is distributional neutrality or, indeed, better than distributional neutrality.

Senator Mitchell. Well, my time is up. Let me just conclude by saying if you believe that, if your policy was consistent with what you have just said, you would be in here opposing this oil import fee, and certainly in the context of the tax reform bill.

Mr. Mentz. Well, no; because I think——

Senator Mitchell. It would be the opposite of what you are saying.

Mr. Mentz. No; I think it is fixable. I think it is complicated, but it is fixable, and that is the reason that we are not opposing it at this time.

Senator Wallop. Senator Long.

Senator Long. Mr. Mentz, as I understand it, it is your feeling that if an oil import fee is passed, there should be an arrangement to help people with home heating oil. Is that correct or not?

Mr. Mentz. I think there would have to be, Senator Long. I think without it you have a pretty major fairness problem.

Senator Long. Well, the reason I bring that up is that anyone thinking about an oil import fee has recognized that if such a fee is passed, we would undertake to provide relief for areas in New England, for example, where they would have a real problem with heating oil. We would provide better relief for them than we have in the past. I assume that that would be one of the things you would be recommending, wouldn't it?

Mr. Mentz. Absolutely, sure.

Senator Long. So that you don't have in mind having an oil import fee that would not provide relief for home heating oil?

Mr. Mentz. No; nor do I recommend an oil import fee that would not provide some relief from this regressive feature that Senator Mitchell was just discussing.

Senator Long. Your feeling is that when you look at the tax bill that would go to the President's desk, this would be a regressive feature, but you would expect to offset this with progressive features. The net balance would be progressive and would give relief to the low-income people that all of us are concerned about. We want to be fair and drop 6 million low-income people from the rolls, and we don't want to be unfair to anybody that is left on the rolls. Is that fair?

Mr. Mentz. That is precisely correct, Senator.

Senator Long. All right. Now I have lived long enough to have been through some of the energy shortages that we have had. I can recall when we had a defense amendment in the law. That was not my amendment, but I think I voted for it.

The effort was to maintain an energy industry in the United States. Certain criteria were spelled out to indicate what was an essential commodity, what was a strategic commodity, what you would have to have if you were going to survive in an emergency. Energy and oil and gas, in particular, qualified in that context. As a matter of fact, more so than steel. More so than any other commodity.

Are you familiar with that, Mr. Boggs?

Secretary Boggs. Are you referring to the Defense Production Act, Senator?

Senator Long. No; I am talking about the defense amendment that was in the law back in the fifties.

Secretary Boggs. I am not aware of it by that name, Senator.

Senator Long. Where were you at that time, by the way?

Secretary Boggs. 1950, I was starting first grade. [Laughter.]

Senator Long. Well, that is one reason I have a better memory than you. [Laughter.]

Secretary Boggs. Considering you have more to remember, Senator, I am sure you do.

Senator Long. I can remember more.

During those times, it was well recognized that we would have to have an energy industry to see us through an emergency. For example, as important as a tank is, that tank is not going to be much good if you do not have some fuel to move it around with.

I guess you know—although it is long before your time—that when Hitler invaded Russia, he did it because he felt he had to have enough fuel available through quite a long war.

Now there are some who came into Government and the military who took the attitude that we did not have to worry about the energy industry. If we have a war, it will be a short war. It might be all over within 48 hours. We can just take it off the stockpile, or take from the civilians what we need to see us through an emergency, and just tell the civilians to get out and walk and do without heating the home for a while until this thing is over with. It will not last very long. We will all either be dead or the other guys will be all dead within 48 to 72 hours.

If you are thinking in those terms, you do not really need an industry to see you through any emergency.

Let me ask you now. You were not even in high school at the time I made reference to, and I wonder how could I be so old. But I was around here during that period.

From 1956 to 1973, a period of 17 years, the policy of this Government permitted the imports to increase and increase and permitted our industry to continue to shrivel and decline until by 1973, the way I heard it from people in our industry, they were just producing out of inventory. They were drilling practically no exploratory wells, and not even many development wells where they had found oil.

Do you have any recollection of that?

Secretary Boggs. I have seen the statistics on it, Senator.

Senator Long. But no direct recollection of it?

Secretary Boggs. No, sir.

Senator Long. Now do you recall what happened in 1973 when we were hit with the Arab boycott? President Nixon was President at that time. Do you recall that?

Secretary Boggs. Yes, sir.

Senator Long. Do you recall that President Nixon and Bill Simon—I think he was the energy man when it first hit—do you recall that they thought at that time that it had been a disaster and it had been unwise for this Nation to permit our energy industry to decline to the point that it could not provide our essential needs or see us through the type of emergency we faced?

Do you recall that President Nixon at that time announced Project Independence? That we were going to become energy independent because it was essential to the survival of our country and the welfare of our people? Do you recall that?

Secretary Boggs. In general, not in detail. But in general.

Senator Long. Did somebody tell you about some of it?

Secretary Boggs. I was involved in nonenergy pursuits at the time, but I know in general.

Senator Long. What were you doing at that time?

Secretary Boggs. I was assistant to the Solicitor General of the United States at that time.

Senator Long. Assistant to the Solicitor General.

Well, I think it would nice if sometime you lawyers would look around and see what is going on elsewhere. [Laughter.]

But, anyway, another oil crisis hit us in 1979. Secretary Schlesinger was then called in. He was the former Secretary of Defense.

What kind of recollection do you have of that time? Where were you then?

Secretary Boggs. I was working for the Senate Energy Committee, sir.

Senator Long. Senate Energy Committee?

Secretary Boggs. Yes, sir.

Senator Long. Well, may I say that that does not speak well for them in my judgment. I can't recall that they achieved a lot.

Secretary Boggs. You could speak to Senator Hansen about that.

Senator Long. Well, the best I can recall of it, Senator Hansen and myself and Senator Fannon, who was also on that committee, I believe, at that time, fought against what came out of that committee. We felt it was counterproductive; it would do more harm than good.

Secretary Boggs. You are exactly right, Senator.

Senator Long. I recall back during those days that Helmut Schmidt, Chancellor of Germany, came over to talk to President Carter. He told us at a meeting at Blair House that turning down the thermostat and the 55-mile-an-hour speed limit and all those little things would do some good, but he said, "You are not going anywhere with this energy crisis until you do what we Germans have done. Until you are ready to let that price go up, you people are not going to get anywhere with this energy problem."

Secretary Boggs. You are exactly right, Senator.

Senator Long. So you agree with that analysis of it at that time?

Secretary Boggs. Absolutely.

Senator Long. I know that I told him that the chances are you are not going to get anywhere with what you are saying here in this country now. But when President Carter comes over to visit you in your country, you ought to bring that up among your colleagues and try to educate the President when you get him over in your territory. So they met in Tokyo. President Carter came back and said he had the worst day he had ever had in his life over there, by the time these Europeans and Japanese and others got through reading the riot act to the United States that we were not facing up to this emergency.

Now it seems to me that you are just willing to let nature take its course when we have done that before and it wound up being a disaster.

Secretary **Boggs**. Well, Senator, I would be happy to respond to that, but I understand Mr. Greenspan is waiting, and I would be happy to respond to it later.

Senator **Wallop**. I am going to ask the witnesses not to depart because Senator Bradley has not had an opportunity, and there may well be other questions. But I would very much like to hear from Alan Greenspan before his plane departs and we only receive an echo.

Senator **Bradley**. Mr. Chairman, are the witnesses going to remain?

Senator **Wallop**. They are.

Senator **Bradley**. They are.

Senator **Symms**. Mr. Chairman, while Mr. Greenspan is coming up, I want to apologize to the next panel that I have to leave. I have another meeting I have to be at. But I wanted Senators Bradley and Mitchell to note that this Robert E. Hall that will be testifying later is the Hall from Hall-Rabuska that we heard so much about in West Virginia. I apologize to you also.

Senator **Wallop**. Mr. Greenspan.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, NY

Dr. **Greenspan**. Mr. Chairman, let me express my appreciation for your courtesy in accommodating a set of previously significant commitments.

Senator **Bradley**. Mr. Chairman, I cannot hear Mr. Greenspan.

Senator **Wallop**. It is one of the things about this committee that the microphones are state of the art, but the art of which they are the state is about 1912.

Dr. **Greenspan**. We are in an extraordinary position at the moment where we are not sure where the oil price is going to settle. What is occurring in today's market is a continuous marking down of oil prices, which is what is required so long as production exceeds world consumption.

And at the moment, that looks to be somewhere in the area of $1 to $2 million a day on a seasonally adjusted basis. This means that unless production is cut back either from OPEC or from other sources, specifically the stripper wells in the United States, that we will continue to erode the price until we finally get down to levels which are sufficiently depressive to pull wells out of production. And even though I have listened to Senator Boren's remarks about where he thinks the marginal lifting costs in the United States are, that is not my recollection of what the data show. I grant you that lifting costs of a good number of the stripper wells are quite high. The average lifting cost—this is strictly lifting cost—as I recall the numbers, are below $10 a barrel for the total oil and gas system. That is not to say if prices do fall to $10 there would not be chaos.

But it is also incorrect, I think, to presume that there would be very substantial cutbacks.

The problem, however, is that if we do not get world production cutbacks at these price levels in the area of 1 to 2 million barrels a day, then the break in prices has to fall to the $10 to $12 area where the first significant cash loss on wells throughout the world begins to occur.

And if that were to occur, then I think we have a very extraordinary set of circumstances.

Let me say, Senator, with respect to the issue which is the crucial question—the national security issue—I do not think there is any question that the current sharply lower prices in the oil products market will, if they prevail for a number of years, tilt the level of oil consumption higher in the United States.

Obviously, lower prices will also significantly curtail the incentives for oil and gas exploration and development and, hence, productive capability would surely fall from the current level of 9 million barrels a day for crude.

The rise in imports under that scenario would, of course, be potentially quite significant and, again, expose the American people to increasing dependence on OPEC oil with all of the potential disruptions that we experienced during the last part of the 1970's.

There are, however, several caveats to this scenario. First, American homeowners have for a decade or more accelerated the insulation of their homes, and in the process have significantly reduced the demand for distillate fuel oil. Obviously, even at markedly lower home heating oil prices, that insulation is not about to be stripped out so that homeowners can use more cheap oil. Nonetheless, the intent and incentives to fully insulate newly constructed homes will fade and over an extended period of time, should prices remain low, consumption of home heating oil would rise, perhaps significantly.

Similarly, it does not seem credible that having made the major transition to fuel-efficient engines that technology would be reversed and we would be back producing gas guzzlers. Nonetheless, here too the incentive to buy larger cars even with fuel-efficient engines will clearly increase, and the average fuel efficiencies of our motor vehicle fleet will fall.

Similarly, there are myriad shifts toward oil conservation which are not readily reversible since they involve new ways of doing things. However, markets in the end do work. Consumption will rise as prices fall.

Nonetheless, the consumption rise is likely to be neither rapid nor substantial. Obviously, if the rise in consumption could be fended off and our dependence on OPEC oil in the future rendered less severe, it would clearly be desirable to seek such a goal.

It is not clear, however, that an import tax or any other tax on oil will succeed effectively in doing that so long as the rest of the world is enjoying the benefits of lower oil prices.

The United States has far more integrated into the world economy than ever before and must compete. An oil tax raises the cost of production across the board, but since industries use energy in different degrees of intensity, the loss of competitive position vis-a-vis the rest of the world would tend to be in energy-intensive industries. To be sure on average, that could be offset by a decline in the exchange rate of the dollar. But while the average could be adjusted, the dispersion of differential costs depending on energy intensity cannot. Clearly then, unless there is a multinational agreement simultaneously to impose taxes on oil reflecting the decline in crude price, an oil tax, like so many other taxes, will decrease American competitiveness.

It is not enough merely to refund the tax equivalence on American exports of petroleum-based products, such as petrochemicals. It would require the unimaginable task of refunding the oil tax equivalent on all American exports and, more importantly, imposing separate taxes on all foreign goods entering the United States according to their estimated energy context.

In summary, an oil tax will have a negative effect on long-term economic growth. And so long as our trading partners book lowered oil costs into the cost structures, it will be difficult for us to hold our internal oil price structure up.

Thank you, Mr. Chairman.

[The prepared written statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

before

United States Senate
Committee on Finance
Subcommittee on Energy and Agricultural Taxation

February 27, 1986

....

The inability of OPEC to hold production at levels consistent with demand has created the expected break in world oil prices.

Prices must continue to fall until OPEC brings production back to the level of demand and until inventories, which I expect to rise by one to two million barrels a day, seasonally adjusted, through the first half of the year, stabilize. I have assumed that liftings from OPEC will decline from their present level of 17 million barrels a day to under 16 million barrels a day by the third quarter. This would be consistent with a stabilization of refinery acquisition prices for domestic crude oil at approximately $18 a barrel and average wellhead prices, excluding Alaska North Slope, of $17.

However, should OPEC or other producers fail to scale back liftings by 1 million to 2 million barrels daily by summer, i.e., to those output levels which are consistent with stabilizing inventory, then prices could be pushed still lower. Indeed they would continue to erode so long as production exceeded consumption and inventories rose. In today's market, successively lower prices are required to induce private consumers to hold ever increasing levels of inventories. It is only when the inventory change goes to zero that prices stabilize. It is, therefore, not inconceivable for a secondary break in the market to bring wellhead prices into the $10

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*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

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to $12 range, the point at which the first clear cash losses become evident on some crude production in the United States and perhaps the North Sea.

The break in world oil prices will, of course, have an input on the prices of other fuels. For natural gas to compete successfully in industrial markets with residual fuel oil, delivered prices of deregulated natural gas will have to decline. However, the bulk of gas is regulated at prices below the competitive equivalent of fuel oil. Hence, the average natural gas price decline should be a fraction of the decline in oil prices. A secondary break in oil prices to the $10 to $12 a barrel range, however, would pull the whole gas price structure with it.

Prices of coal essentially have been decoupled from oil prices since the oil price run-up in 1973-1974. At that time coal was substituted for fuel oil by every industry and utility that had the capability. If a second price break occurs, fuel oil would come into the range at which it again would be competitive with coal, leading both to an increase in demand for fuel oil and downward pressure on coal prices. Even so, some easing in coal prices is likely, currently, since oil is more competitive with coal in the export markets. Hence, weak export demand would translate into some downward pressure on U.S. coal prices.

In short, while the oil price decline to $17 a barrel will have modest effects on natural gas and coal prices, a break in oil to the $10 to $12 range would bring all energy prices down in tandem. The impact on companies and financial institutions clearly would be far greater than the effect to date.

The notion of an oil import fee has arisen recently in part owing to the presumption that raising oil taxes as oil prices slump will be politically easy. The tax is considered as a revenue raiser, or as a device to prop up domestic oil product prices to prevent a resumption of oil consumption growth and an eventual replaying of the United States OPEC dependence of the latter part of the 1970s. Any of the number of taxes on oil can achieve either or both of these objectives, an oil import fee, a refinery acquisition tax, a gasoline tax at the pump, a Btu tax, immediately come to mind.

The goals of lowering dependence on OPEC and/or raising revenues are, of course, worthy goals, though both eliminate the immediate advantages which will accrue from the significant declines in prices already under way. However, leaving a gasoline tax aside it is implicitly assumed that an oil tax can be phased in to absorb the decline in crude oil costs before it is reflected in the retail price of petroleum products. It does take several weeks before the declining spot price affects the average price of crude oil at domestic refineries and further days or weeks pass before this lower refinery acquisition cost results in competitive reductions in product prices for gasoline and home heating oil. There seems to be no possibility, however, that a tax could be imposed during this period in a manner which effectively would absorb the decline in crude oil cost before it affected the price of products. Any authorization of an oil tax is likely to occur only weeks or possibly months after product prices have fallen. Consequently, since price declines of that nature are quickly perceived by consumers as a "right," the imposition of a tax which restores the product prices currently prevailing is by no means the same policy as absorbing the decline in crude oil prices without touching the price of products. The political problems of raising taxes on oil after product prices have come down will be of much the same dimension as raising any other tax.

There is little question that the current sharply lower prices in the oil products markets will, if they prevail for a number of years, tilt the level of oil consumption higher in the United States. Obviously, lower prices will also significantly curtail the incentives for oil and gas exploration and development and, hence, productive capability would surely fall from the current level of 9 million barrels a day. The rise in imports under that scenario could, of course, be potentially quite significant and again expose the American people to increasing dependency on OPEC oil with all of the potential disruptions that we experienced during the latter part of the 1970s.

There are, however, several caveats to this scenario. First, American home owners have for a decade or more accelerated the insulation of their homes and in the process have significantly reduced the demand for distillate fuel oil. Obviously, even at significantly lower home heating oil prices, that insulation is not about to be stripped out so that home owners can use more cheap oil. Nonetheless, the incentives to fully insulate new homes will fade and over an extended period of time, should prices remain low, consumption of heating oil would rise, perhaps significantly. Similarly, it does not seem credible that having made the major transition to fuel efficient engines, that technology would be reversed and we will be back producing gas guzzlers. Nonetheless, here too the incentive to buy larger cars, even with fuel efficient engines, will clearly increase, and the average fuel efficiencies of our motor vehicle fleet will fall. Similarly, there are myriad shifts toward oil conservation which are not readily reversible since they involve new ways of doing things.

However, markets in the end, do work. Consumption will rise as prices fall. Nonetheless, the consumption rise is likely to be neither rapid nor substantial.

Obviously, if the rise in consumption could be fended off and our dependence on OPEC oil in the future rendered less severe, it would clearly be desirable to seek such a goal. It's not clear, however, that an import tax, or any other tax on oil, will succeed effectively in doing that, so long as the rest of the world is enjoying the benefits of lower oil prices. The United States is far more integrated into the world economy than ever before and must compete. An oil tax raises the costs of production across the board. But since industries use energy in different degrees of intensity, the loss of competitive position vis-a-vis the rest of the world would tend to be in energy intensive industries. To be sure, on average, that could be offset by a decline in the exchange rate of the dollar. But while the average could be adjusted, the dispersion of differential costs depending on energy intensity, cannot.

Clearly then, unless there is a multinational agreement simultaneously to impose taxes on oil reflecting the decline in crude prices, an oil tax, like so many other taxes, will decrease American competitiveness. It is not enough merely to refund the tax equivalence on American exports of petroleum based products such as petrochemicals. It would require the unimaginable task of refunding the oil tax equivalent on all American exports and, more importantly, imposing separate taxes on all foreign goods entering the United States according to their estimated energy content.

In summary, an oil tax will be neither politically easy nor economically neutral.

Senator **WALLOP**. Just one question. Even with a rise in consumption of imports having been fended off—no, even with a rise in consumption having been fended off, as you suggested might be the case, wouldn't we still be seeing a significant decline in U.S. production with a decline in price?

Dr. **GREENSPAN**. Mr. Chairman, I think we have to look at several different aspects of this problem. If the price of crude in the world markets—let us say the spot or even the refinery acquisition cost of West Texas intermediate crude, say, goes down to $10 a barrel, there will be a significant amount of wells shut in at that time. But remember that can only happen if there is a major world oil glut.

And the question, therefore, is: What do we do for energy security under conditions that we currently face?

My view is that we set up the strategic petroleum reserve to handle an issue like this. If, for example, we stay at $10 a barrel for a while, which I think if we got down to, we probably would, at some point we must assume we will be coming back, because at those price levels we will be shutting in a good number of American wells.

The question that I think has to be addressed is not the issue of decline in capacity or productiveness, but is it feasible for American oil companies to be in a see-saw position where they find, for example, at $10 a barrel, we shut in 3 of our 9 million barrels a day but if the price then escalates back up to $20 or $25, those wells then become profitable.

There are costs of shutting in wells and bringing them back. There are problems in drilling replacement wells in order to keep the capacity of our oil and gas underlying system in place. I doubt very much that that should be done through an oil import tax or any tax which artificially holds the price up.

If we deem that a national security issue, cash outlays over and above that which individual oil companies would be required to absorb, should then become a Defense Department expenditure, a Defense Department subsidy or an outlay for that specific purpose.

In my judgment, we do not do it correctly by endeavoring to lock a price in, say, through an import tax, in order to get an indirect effect. We can probably do better without the distorting effects that would occur from that particular tax.

Senator **WALLOP**. Senator Chafee, I am going to ask us to limit ourselves to one question because the time does move.

Senator **CHAFEE**. I am delighted to hear the testimony of Dr. Greenspan.

Senator **WALLOP**. Senator Boren.

Senator **BOREN**. Mr. Greenspan, I would just say that I was citing a Rand study which included also excise taxes and so on so that you easily get up to that level if you include the taxes on average cost of production. You usually get up to the $12 level.

Let me ask you this question: You did concede that at a certain point we could have a national security problem if we were to destroy the infrastructure and all of the related service and supply of the rest of the industry, even the educational base in terms of being able to recreate our domestic industry if it were, let us say, in essence, shut down and you needed to reopen it for some reason or if a substantial portion of it were shut down.

How, then, would you deal with that problem? You said that you would not deal with it through an import fee. If prices were held down long enough and the West Texas crude and the spot market is down to $13—so I do not think we are talking very hypothetically at this point—and the Saudis have certainly showed their ability. How long they could sustain it, we do not know, but they have shown their ability to manipulate the international price of oil right now down to relatively low levels. I think the lifting cost is down around a dollar and a half or something like that. So they could go much lower, and they could increase their production above levels where it is now.

If you really had to deal with that kind of situation where the drop was prolonged enough that it did damage our national security potential, how would you deal with it then? How would you recreate the domestic industry, get the people to study in petroleum engineering again, keep the supply houses and the pipe supplies and the drilling? The rigs are going to rust out if you stack them for—how would you do it?

Dr. **Greenspan**. Well, Senator, you don't solve a problem, as you put it, all that simply. Let me answer that in two phases.

I do not think that an oil tax will do what it is you are endeavoring to do. It may very well prop up segments of an industry on a standby basis, which is essentially what it would be endeavoring to do. That is, we would be subsidizing production of crude oil or subsidizing the maintenance of an active productive capacity with a variable shut-in well system at a very substantial cost to the economy. In my judgment, it would be on national security grounds, a cost far in excess than I believe the cost involved of an import tax or any form of tax that we would impose to do that.

I agree with you that it would be quite dangerous to allow our infrastructure of our oil and gas system to unwind if we could possibly avoid it. And I emphasize if we can possibly avoid it.

If somehow the cost of production would stay very high for our domestic system, we would have some major problem such as the way we approached—and I don't mean this facetiously—the shale oil problem which we did not succeed in resolving.

However, let me make a point about oil costs, which I think are important.

Senator **Boren**. I am sorry. I did not quite understand what you suggest we do to keep the infrastructure.

Dr. **Greenspan**. Well, as you remember, we had a major bid program to buy shale oil so that we would enable companies to produce shale oil significantly above the cost of——

Senator **Boren**. So you would put the Government in the oil business either as the major direct purchaser or as the producer?

Dr. **Greenspan**. That is, in fact, what we did.

I do not like that, let me say. While it is certainly the case, especially if you add the taxes to your lifting cost, that the basic cost of lifting oil onshore now is a little below $10 a barrel on average, it has not always been that way. It went up very significantly during the 1970's largely because we began to capitalize in the underlying lifting cost of oil the significant increase in the value of drilling operations and the whole drilling infrastructure.

Were it the case that we were sitting at a $10 crude oil price level for a protracted period of time, I suspect that within a few years the cost of lifting would, in the terms in which we are defining it, come down really quite significantly, because there is a lot of declining capitalized drilling cost implicit in those numbers.

But let me just answer your question as best I can. I certainly share your concerns that you are raising. I think it is a little flip for somebody to come up here and solve a problem like that in a hearing when it is an extraordinarily complex issue. I went through that whole energy problem because I came into the Ford administration in August 1974 and it was sufficiently close to the chaos that had occurred previously to know all of the various problems that are involved.

I find that having been exposed to this issue, that we should be able to do what we are trying to do in a better way than solving it from the tax side.

Senator **WALLOP**. Senator Bradley.

Senator **BRADLEY**. Thank you very much, Mr. Chairman.

Mr. Greenspan, I want to thank you for your testimony. I think that you make one point that I had not sufficiently thought of before. You are saying that if you put an oil import fee on, you are raising the cost of production for any industry, any export industry, that uses oil.

Dr. **GREENSPAN**. Yes.

Senator **BRADLEY**. And that when that industry competes with foreign industries in the same sector, we are at a competitive disadvantage at that point.

Dr. **GREENSPAN**. That is right.

Senator **BRADLEY**. And the likelihood is to increase our trade deficit as a result. Is that not correct?

Dr. **GREENSPAN**. That is correct, Senator. Either that or what will occur is a distortion in the mix because remember that if our current account balances, gets extreme, then the rate will begin to adjust as, in fact, I think it is doing now.

The problem, unfortunately, is there is no way for an average exchange rate to offset the differential impacts, by industry, because energy intensive use is quite dramatically different by industry.

Senator **BRADLEY**. So essentially what it is is a tax on our exports?

Dr. **GREENSPAN**. Partly, yes.

Senator **BRADLEY**. And it is an indirect subsidy to imports?

Dr. **GREENSPAN**. Well, yes. To other people's exports.

Senator **BRADLEY**. Other than oil?

Dr. **GREENSPAN**. Yes, sir.

Senator **BRADLEY**. Given that a drop in the price of oil is similar to a gigantic tax cut, what does the present drop in the oil price imply in terms of increased growth for the economy?

Dr. **GREENSPAN**. In the longer run, it reduces the cost of production net to the total system and will raise the level of GNP at some point.

However, we have to remember that the effects of the oil price decline cut two ways in the United States. If, for example, exploration and development expenditures across the board in 1986 get cut by, say, 20 percent, that is the equivalent of almost 1½ percentage points in total plant and equipment expenditures. And that would have a significantly negative impact as appropriations go out and begin to basically supress the system.

You also have got clear problems, which I believe Senator Boren raised, with respect to the financial system. It is not so much that the price of oil is dropping; it is that it is dropping so rapidly. You have to remember that the portfolios of financial institutions cannot turn over that quickly, and, therefore, they are in very serious trouble.

In addition, we have 1 billion barrels of oil in the private inventory system of the United States. And we have just taken $6 to $8 billion of market value out of the system in a period of very few weeks.

We do not know yet the significance of that, but one thing on which we can be relatively certain of is that the negative effects of the oil price decline are there as well as the positive. It is very easy to argue in terms of the positive effects, which in the long run are unquestionable, but we are about to go through a very unsteady period in which both forces will be at work.

Senator BRADLEY. Would you say that net is a positive effect?

Dr. GREENSPAN. Yes; I would.

Senator BRADLEY. The net is a positive effect?

Dr. GREENSPAN. Yes.

Senator WALLOP. Alan, I promised you that I would get you out of here at 25 past, and I think I had better try to live up to that. I am sorry that it took us so long to get to you.

I would just make an observation that one of the things we seem fated to have happen to us, and the line of questioning from Senator Bradley, is a rise in our balance-of-payments deficit, because with the reduced price, we are going to have a larger balance-of-payment deficit caused by greater imports. If you do it the other way, as you suggest, we are going to have a rise in the balance-of-payments deficits by virtue of subsidized imports. It does not look like a very good time.

Senator BRADLEY. No. He did not say that, Mr. Chairman.

Senator WALLOP. Well, your question was rather simple: Wouldn't there be a rise in the trade deficit if we impose a tax? The answer was "Yes." Without the tax, it is going to cause a rise in one, too; because we are going to have greater imports.

Senator BRADLEY. We are going to have greater imports of——

Senator WALLOP. Of oil and gas.

Senator BRADLEY [continuing]. Oil. But let me ask Mr. Greenspan, then. On balance, would you say there would be a greater increase in the trade deficit by virtue of putting an oil import fee on?

Dr. GREENSPAN. That is not the crucial issue. I hate to argue the terms of whether or not we put an oil tax on at the border as a trade issue. I think it is a mistake to discuss it in those terms.

Senator WALLOP. With that, I will let you escape before we open it again. I appreciate you coming here.

Senator MITCHELL. Mr. Chairman, may I be afforded one comment? If you have got just 1 minute? I would like to make one comment. I did not have a chance to ask questions.

Dr. GREENSPAN. All right.

Senator MITCHELL. Mr. Greenspan, you testified just a few weeks ago before this committee as to the effect that tax reform would have on the international competitiveness of U.S. industry. This room rang with rhetoric at that time about the need not to take any action which would adversely affect the international competitiveness of Americans.

And I think it is significant that the testimony that you have given today is, in my judgment, as relevant to that hearing as it is to the subject here today. You have made what I think is a cardinal point in the testimony today. And I would hope that all the committee members would include that point in their consideration of this oil import fee issue.

The question of oil import fees did not come up then, but it is obvious that the effect of this proposal is truly significant in that context. It is obvious that an oil import fee would have dramatically more of a detriment on U.S. international competitiveness than would tax reform.

Senator WALLOP. There will be time to restate and restate and state it again on this thing, but I did promise Dr. Greenspan that he could escape. And I really feel that I must get him to the airplane.

Dr. GREENSPAN. I appreciate your courtesy, Mr. Chairman.

Thank you, gentlemen.

Senator WALLOP. Would Mr. Boggs and Mr. Mentz come back, please.

Senator BRADLEY. Mr. Chairman?

Senator WALLOP. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. Let me tell Mr. Boggs that I have been waiting for a long while to have a witness come before the committee and make the case on energy security that you have made today. And I think that it merits a restatement of what your case is. And I would like to, if I could, summarize it and then have you amplify and/or disagree with what I have said.

Your case is essentially that energy security is a problem of dependence on insecure sources of foreign oil, and that if we imported less oil than we do today and there was an oil supply disruption which caused a dramatic price increase, that the United States would bear the biggest burden of that price increase given an open, decontrolled market, because we are the biggest consumer of oil, and, therefore, we would have to pay the biggest increase in total dollars in the price.

And you say further that the way to counter that is to have an adequate stockpile of oil that can moderate that price increase. Is that not correct?

Secretary BOGGS. Yes, sir. I would say you probably would have been more successful as a witness with some of the Senators than I have been thus far.

If I might say one or two things before we go on because it is partly in response to Senator Long. We are certainly concerned about national security aspects. They are captured somewhat but not entirely by measures like our import dependence, like world surplus capacity, and like the price level.

Now if we had gone back to 1981 and were told the prices in 1985 were going to be half of what they were at that time, where we told people we were adopting the Reagan energy policy, we were told that imports will rise, that OPEC will be in control. It certainly would not have been sensible to have been scared out of that policy and not gotten the benefits that we got.

Now can there be too much of a good thing? Probably yes. But to say that at $30 or at $22 we have to turn the policy around and try to deliberately raise American energy prices without seeing what has happened—because we were told several years ago that imports were going to start shooting up, and some of us said that wasn't going to happen—it turned out that we were right. That to go in and certainly at these levels maintain prices, raise prices for that reason, is, in our view, not sensible.

Senator BRADLEY. I think that we cannot emphasize that point enough. And I thank you for your testimony.

Now, Mr. Mentz, in your testimony you have said,

> I wish to emphasize the administration's strong opposition to any tax increases, including any new or increased taxes on petroleum or energy sources for any purpose other than as a component of a fundamental tax reform bill that is revenue neutral in total.

Revenue neutral in total. And in your testimony, you have provided us with the distributional effects of an oil import fee, which I understand Senator Mitchell has gone over. And the distributional effects are that income levels at $10,000 to $15,000 would have a significant increase in taxes, even when the tax reform proposal of the President is factored in. And that the combination of the President's proposal and an oil import fee woud be an increase in taxes on middle-income people.

Now you have also said in your testimony that, of course, you do not want such a tax increase, and that you can mitigate such a tax increase by adjusting the rate schedule or by providing a refundable tax credit. Now my question to you is: If you take a tax reform proposal and factor in the oil import fee and you adjust the rates or provide a refundable tax credit to improve distribution, don't you then lose revenue and you don't have a revenue neutral tax reform bill, but one that increases the deficit?

Mr. MENTZ. Well, to back up, I will just repeat what I said at the beginning. The administration's strong preference is that tax reform get done without regard to or without drawing upon some other source of revenue. So that would be the preferred objective, which I understand is yours as well.

Senator BRADLEY. Right. So that the administration at the foundation remains committed to tax reform as defined as eliminating loopholes and lowering tax rates?

Mr. MENTZ. That is correct, Senator.

Senator BRADLEY. And the more loopholes you eliminate, the lower you can get the tax rates? The fewer you eliminate, the higher the tax rates have to be? As a principle, you are still committed to that?

Mr. MENTZ. Absolutely, Senator.

Senator BRADLEY. But you have said that what——

Mr. MENTZ. Well, what I am saying is that having gone through the experience in the House—and you all are about to have the experience in the Senate Finance Committee—it is not as easy as it sounds to eliminate loopholes and get the tax rate down. You would be surprised at how many folks will come into you and point out that what you thought was a loophole turns out to be a very important preference that is needed for one reason or another critical to the economy.

So all I am saying, Senator, and all the administration is saying is if we get down to the 11th hour and we are almost to the point of reaching a tax bill that does all the things that a majority of the Senate and the House want it to do and we can't quite bridge the revenue gap, it would be within the realm of consideration of the administration to consider an oil import fee. And the consideration would have to be in a way that as modified would produce the overall distributional effects that are acceptable.

If you don't produce any revenue from it, then it is not acceptable. If it can be done with targeting the relief, as Senator Long suggested, to not just the low income but also the home heating oil, the Northeast and so forth—if that can be done, and you still produce enough net revenue to make a relevant factor in tax reform, then we would suggest you leave it on the table.

I don't think you are going to be able to reach those conclusions until you get further into tax reform. And that is why, although my testimony has been unfairly characterized as straddling the issue, I am really just trying to keep this on the table because I think when you get into tax reform further, we will all have a greater appreciation of how tough that exercise is.

Senator **Bradley**. Essentially, you do not want the addition of an oil import fee to increase the taxes on middle-income people.

Mr. **Mentz**. Absolutely not.

Senator **Bradley**. And you would require that there be changes in the reform package that would make the incidents of the tax no different, the distributional effect, than current law. Is that correct?

Mr. **Mentz**. In fact, I hope we could improve on current law, as the President did and as the House did.

Senator **Bradley**. Well, I think that that is a very important statement, Mr. Chairman, because one of the things that we will want to calculate here is not only the amount of revenue that we raise so that it is revenue neutral, but the distributional effect. And that is not even counting an eventual tax increase to reduce the deficit.

Mr. **Mentz**. Which we are not going to have.

Senator **Bradley**. And so I think that you have complicated our life, sir.

Senator **Wallop**. I would just observe that I would hope that you would follow through on those same sentiments and join Senator Boren and me and others in the elimination of windfall profits tax, if it concerns you.

Senator **Boren**. That would greatly lower the excise taxes and the cost of production and all the rest of that.

Senator **Wallop**. It has pretty well been eliminated.

Senator **Bradley**. I will say to the chairman that I have said for a number of years that that is something that I would be prepared to do if we got to a world where we could have a fully decontrolled market, and as I believe that we don't want to put a floor, so I think we might not want to——

Senator **Wallop**. If it is not decontrolled, it is out of control. We will put it that way.

Senator Mitchell had an observation, and then I am going to ask that we move to the remaining panels.

Senator **Mitchell**. Just what I think is a necessary correction, Mr. Chairman.

Mr. Mentz, after I asked you questions about the distributional effects of the proposals, Senator Long asked you whether you would be talking about a home heating oil exemption so that the net effect would not be as suggested. And you responded yes.

I ask you to look at your own tables, at tables 1 and 2 of your testimony. Is it not true that the figures that I cited include consideration of an exemption for home heating oil, and that, in fact, in another column in your own table there are estimated changes in the tax burden without the exemption, which are even more disproportionate than the ones I suggested.

Mr. **Mentz**. Well, that is right, Senator, but I think what I was referring to in my response to Senator Long was that in order to get your distributional result to come out, you are going to have to do more. And it is not just home heating oil that causes the problem here. It is gasoline. It is other fuels that are impacted by what will be an increase to some extent on other fuels.

So I think my answer perhaps was not construed as broadly as it should have been, which is that you have got to fix all of that so that the distributional problem is corrected.

Senator **Mitchell**. Well, I understand that. But the clear implication of the question and the answer was that the figures that I cited did not include consideration of an exemption for home heating oil. I merely think the record ought to reflect the fact that the distributional effects, the figures I cited, were from your table and included consideration of an exemption. And that, in fact, in another column in your own table, the distributional effects are far worse in terms of the adverse effect on low income.

Senator **Wallop**. May I suggest that I make an observation. We have 11 witnesses yet to go. It is now a quarter to 12, and as fascinating as it is will not be fascinating to anyone else if we continue on this side.

I would suggest that probably the administration will entertain written questions directed to these points.

Secretary **Boggs**. Certainly, Senator.

Senator **Wallop**. Thank you both very much. I appreciate it.

Mr. **Mentz**. Thanks, Mr. Chairman.

Senator **Wallop**. The remainder of the third panel consists of Dr. Robert Hall from the Hoover Institution; Dr. Henry M. Schuler; and Dr. Fred Singer. Dr. Schuler is from CSIS at Georgetown, and Dr. Singer is from George Mason University.

STATEMENT OF DR. ROBERT HALL, SENIOR FELLOW, HOOVER INSTITUTION, AND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

Senator Wallop. With gratitude for your patience, I welcome you all.

Dr. Hall, would you please begin?

Dr. Hall. Thank you, Mr. Chairman. I am grateful for the opportunity to present opinions about the oil import fee to this subcommittee. I have a fairly extensive written testimony which I will only summarize briefly here.

My position on this is very simple to state. An oil import fee is bad for the economy in general. It is bad for consumers. It is bad for workers. It is especially bad for farmers. Its only favorable impact is on the domestic oil, coal, and gas producers, and that benefit is far outweighed by the generally adverse effects on our Nation's economy.

I would point out—and I think many other witnesses have pointed out as well—that the decline in oil prices that has occurred over the past few months has been an outstandingly favorable event for the U.S. economy. You could hardly ask for better news than an event which stimulates employment and cuts inflation at the same time.

We have seen the unraveling of the tremendously adverse effects that occurred in our economy in 1974 and again in 1979 when OPEC raised the price of oil. All those things reversed themselves when oil prices declined.

The oil import fee, very simply put, would deny us the benefits of reduced oil prices. And those benefits are so much larger than the cost, which admittedly is more in some sectors of our economy by lower oil prices, that the net national interest is favored by allowing U.S. customers access to the bargains that are now available in the national oil market.

Let me discuss in more detail some of the particular things that occur, especially the macroeconomic benefits of the oil slump. That is my specialty—macroeconomics. And I have examined that very carefully, again, in the opposite direction originally when oil prices went up. I examined the damage that was done to the economy. Now looking at it in the reverse, I find that there are very substantial benefits in the form of reduced inflation and stronger economic activities.

I think a number of macroeconomists, including the Chairman of the President's Council of Economic Advisers, have already indicated how strong that real effect is. It is, in my estimation, as much as 2 percentage points of GNP improvement thanks to lower oil prices. And we would lose those 2 percent of real GNP if we imposed an oil import fee that reversed that decline in oil prices.

Two percent of real GNP is about $50 billion in income for American families, far in excess of the income lost in energy-producing sectors. And, again, that simply illustrates and underlines the importance to the national economy of lower oil prices.

Another factor that I would call to this subcommittee's attention is that the decline in oil prices has been responsible, among other things, for the return of the dollar to a more sensible level and the restoration of competitiveness of American industries across the board. And that is a very important influence as well.

We are taking pressure off the demand for imports because imported oil, which is dominant among our imports, is so much cheaper now. Consequently, the dollar has depreciated.

To put an oil import fee on would cause the dollar to appreciate again. That would be bad for agriculture, and it would be bad for industry in general. We must pay attention, as I think we have learned repeatedly over the last two decades, to what happens to the value of the dollar.

We cannot ignore the impact of an oil import fee on the value of the dollar and on the competitiveness of our export industries which agriculture is foremost.

With respect to national security, I am not the expert on that point, but it is certainly something I thought about. And it seems to me that the national security argument so clearly goes against an oil import fee that I am surprised that that argument would be offered at all.

An oil import fee causes us to burn up our own oil. Our security depends upon maintaining resources, especially standby resources, such as the strategic petroleum reserve. And now is the time when oil is a bargain to enlarge strategic reserves, and that would require more imports; not less.

From the strategic point of view, it seems very clear that proper energy strategy calls for consuming the oil that is available when oil is a bargain. And I have no assurance that oil will remain a bargain, and, therefore, the security argument seems to me like it simply does not go through.

I have already stressed, but let me stress again, that an import fee is bad for the world economy; it would cause the dollar to appreciate. In particular, another aspect of this that should be kept in mind by this subcommittee is that a United States tariff on oil reduces the world price and increases the pressure on friendly oil producers, such as Mexico. And that, I don't think, we can forget. In thinking about the issue of financial instability, which is also important, U.S. banks admittedly would gain in terms of the performance of their energy loans if we had an import fee. But they will lose if we have an import fee in terms of their performance of loans to Mexico and elsewhere to energy producers outside the United States.

We cannot help them; we hurt them by putting on an import fee. And that is yet another reason why such a fee would be disaster for the American economy.

Thank you, Mr. Chairman.

Senator WALLOP. Thank you, Dr. Hall.

[The prepared written statement of Dr. Hall follows:]

THE ADVERSE ECONOMIC CONSEQUENCES OF AN OIL IMPORT FEE

Testimony of

Robert E. Hall

Senior Fellow, Hoover Institution
Professor of Economics
Stanford University

Before the

Subcommittee on Energy and Agricultural Taxation
Senate Finance Committee

February 27, 1986

Summary

An oil import fee is bad for the economy in general. It is bad for consumers. It is bad for workers. It is bad for farmers. Its only favorable impact is on domestic oil, coal, and gas producers. That benefit is far outweighed by the general adverse effect of an oil import fee.

Recent declines in oil prices are having a highly favorable effect on the U.S. economy. The brightening of the outlook over the past few months is almost entirely due to favorable news about oil. Cheaper oil will give higher real GNP, higher employment, lower interest rates, and a more competitive dollar. Real GNP in 1986 promises to be about 1.8 percent higher than it would have been with stable oil

prices.

Proposed oil import fees would reverse part or all of this favorable change in the economy. They could cost the nation some $70 billion in output in 1986 and about $200 billion all told.

Considerations of national security point away from an oil import fee as well. Periods of cheap oil are times when the U.S. should conserve its own resources and take maximum advantage of bargains in the world oil market.

An oil import fee would put upward pressure on the dollar, causing U.S. agricultural products and manufactures to be priced out of world markets once again.

An import fee would further depress the world oil market, creating added problems for Mexico and other friendly nations that are important oil exporters.

Finally, an import fee is completely the wrong way to deal with the financial repercussions of defaults on energy loans. The fee would worsen the problem of loans to Mexico and other foreign oil producers.

Macroeconomic impact of lower oil prices

The decline in the world oil price has invigorated the U.S. economy. Since last summer, the outlook has brightened substantially--forecasts of growth in output and employment for 1986 and later are higher, and forecasts for inflation are lower. Moreover, it is clear that the sharp decline in the price of oil is a major contributor--perhaps the only important contributor--to the improvement in the outlook.

Thanks to the painful lessons of the oil price shocks of 1973-74 and 1978-79, there is a reasonable amount of agreement among macroeconomists about the magnitude of the impact of changing oil prices on real activity and prices in the U.S. The decline of approximately $8 per barrel in effective oil prices will raise real GNP at year-end by about 1.8 percent and lower inflation by about the same amount, 1.8 percentage points.

Spot market oil prices have fallen much more than $8 per barrel. It remains to be seen whether the contract prices governing almost all actual oil transactions will fall as far as the spot market has, or whether the spot market will come back up to the $20 level of contract prices. If contract prices do fall as low as $15, then the favorable macro impact will be even larger. It is even conceivable that 1986 could be a year without inflation, if the news from the oil market is good enough.

One important impact of lower world oil prices is particularly important for U.S. agriculture: Cheaper oil has taken the pressure off the dollar and permitted a movement back toward a reasonable valuation of the dollar. U.S. agricultural products and manufactures now find more favorable markets overseas. The cruel experience of 1982-85, when U.S. products were priced out of many world markets, has come to an end.

Benefits of the oil slump

The benefits to American citizens of the higher real GNP brought by lower oil prices are enormous. Extra growth of real GNP of close to 2 percent will translate into extra real, after-tax income of over $50 billion for American families. In addition, extra government revenue and corporate retained earnings will sum to about $20 billion, thanks to the improved economic conditions brought by lower oil prices.

The benefits of an improved economy are spread widely over states, industries, and groups of workers and consumers. Some of the immediate increases in demand are occurring for energy-using products. Others are taking place because moderating inflation has brought lower interest rates and stronger demand for housing and other interest-sensitive goods and services. All of these immediate stimuli are having second and third-round effects as the income generated in the sectors is being spent in other sectors.

Offset against these benefits is the loss of income and employment in oil and in other primary energy production industries. These losses cannot be ignored; they are particularly salient in the major oil-producing states. However, the losses are included in real GNP. The fact that real GNP rises dramatically shows that national welfare improves, on net, when oil prices fall.

The macroeconomic costs of an oil import fee

This subcommittee is considering bills that would reverse part or all of the impact of the decline in world oil prices. They would impose either a $10 per barrel fee or a sliding fee on oil imports. The effect would be to raise the U.S. price of oil to either $10 above the world price, or to $22 per barrel, under the sliding fee. As long as the effective price of oil remains less than $10 per barrel below its old level, the $10 import fee could actually raise the U.S. price of oil above its level of last summer. On the other hand, as long as the effective price of oil in the U.S. is not much below $22, the sliding fee would have relatively little impact.

Very simply, the immediate net cost of an oil import fee would be the loss of the real GNP increase that would otherwise have occurred. For the $10 import fee, that cost would be about 2 percent of real GNP, or over $80 billion. Moreover, even if oil prices stabilize at their current levels, the stimulus to higher real GNP will continue into future years. The value of the total stimulus lost because of an oil import fee could easily total $200 billion.

With respect to the sliding fee, if the world oil price settles at an effective level of $17 per barrel, so that the sliding fee is $5 per barrel, then the overall macro cost would be half the figures just given. The cost would be around $40 billion in the first year and perhaps $100 billion all told.

Microeconomic costs

In addition to the macroeconomic costs just discussed, an import fee imposes microecomic costs by depriving U.S. consumers of bargains currently available in the world oil market. The fee causes consumers to purchase oil produced in the U.S. at greater cost than the price charged by foreign producers of oil. The extra U.S. production stimulated by the fee is uneconomic and wasteful.

National security

Proponents of the import fee base their case primarily on the proposition that the shrinkage of U.S. production that will occur with lower world oil prices is harmful to national security. Even on its own terms, this argument flawed. If the nation builds a high tariff wall against imported oil, it will deplete its limited domestic resources all the faster.

In the worst case, the U.S. would burn up its own oil during a period when OPEC was weak and the world oil price low, and then turn around and import large amounts of oil just when OPEC gets back on its feet and the world price is high.

Oil is a strategic material and our policy should recognize that fact. But using an oil import fee to keep out cheap imported oil and stimulate the production of expensive domestic oil is not the right answer. Instead, our stragetic policy should take advantage of bargains in the world oil market when they occur. At the same time, it should prepare to deal with episodes of sharp OPEC cutbacks, such as the ones that occurred in 1973-74 and 1978-79. The Strategic Petroleum Reserve is an example of a good standby policy.

Impact of a U.S. import fee on the world economy

Another justification advanced by the proponents of the oil import fee is that the U.S. is such a big consumer in the world oil market that a cutback in U.S. oil imports, achieved by an import fee, will lower the world oil price. As they point out, it is a possibility that part of the cost of an oil import fee will be paid by foreign producers rather than U.S. consumers. Such an argument could be made against free trade in many markets. Three counter-arguments are conclusive, in my view:

First, the argument makes the untenable assumption that nothing else in the world would change if the U.S. put a heavy tariff on oil. In fact, many other nations may respond by putting their own tariffs in place. Free trade is a mutually beneficial, but fragile, equilibrium. A major departure in the form of an oil import fee would further threaten that equilibrium.

Second, the argument completely overlooks the impact of an oil import fee on the value of the dollar. Cheaper oil is one of the reasons that the dollar has declined substantially in recent months. An oil import fee would send the dollar back up to levels that would inhibit the competitiveness of U.S. products in world oil markets. Farmers, in particular, would be injured by the restoration of an overvalued dollar through an oil import fee.

Third, the argument that we should impose an import fee in order to lower the world oil price gives no weight to the impact of even lower oil prices on producers who are long-term allies of the U.S. Much of world oil output today comes from Britain, Norway, Mexico, Venezuela, and other friendly nations. Mexico, in particular, is suffering badly from the decline in oil prices. A proposal that the U.S. should join Saudia Arabia in further lowering the world oil price is hardly a good neighbor policy.

Financial stability

Another element of the case made by some proponents of the oil import fee is that higher domestic oil prices will prevent defaults by oil producers that may threaten the stability of the financial system. However, using the fee to improve financial stability is defective for two reasons. First, whatever gain is achieved in limiting banks' exposure in domestic markets is largely lost by worsening exposure in foreign markets. As I just noted, an oil import fee will further depress the world oil market and add to the problem of defaults by Mexico and other foreign borrowers. Second, even in the domestic arena, we have much better policies for limiting the impact of loan defaults. Through deposit insurance and the discretionary power of the Federal Reserve, despositors are fully protected already. Only the shareholders of banks are at risk. Consequently, the use of an oil import fee for financial stabilization amounts, very simply, to a bailout of the shareholders. Shareholding is the principal mechanism in our economy for the distribution of risk. The government cannot and should not try to limit the risk taken on by shareholders. Shareholders are generally wealthy individuals and are well compensated by the generally high returns from the stock market. There is no good economic case for bailing out shareholders hurt by declining oil prices, either in banking or in the energy industry itself.

Conclusions

An oil import fee is bad economic policy. A fixed fee of $10 per barrel would cost the nation over $200 billion in lost output. A sliding fee that fixed the domestic price of oil at $22 would be less costly today, but could be extremely costly if the world oil price fell further from today's level.

The only economic benefit the nation would derive from an oil import fee is the stimulus to employment and output in the domestic energy industry. Otherwise, the economic impact is entirely negative. The factors I have identified in this testimony are:

1. Macroeconomic costs of $100 billion, $200 billion, or more, taking the form of reduced real income for families, lower retained

earnings available for investment by corporations, and lower real revenue of federal, state, and local governments.

2. Microeconomic costs associated with energy production in the U.S. at costs in excess of the cost of buying the same energy in the world market.
3. The cost to national security caused by depleting U.S. resources at a time when bargains are available in the world market.
4. The cost to U.S. and world trade of a breakdown in free trade exacerbated by U.S. protectionism in the oil market.
5. The loss of competitiveness in agriculture and manufactures associated with the appreciation of the dollar caused by an oil import fee.
6. The damage done to friendly oil producers by the further depression of the world oil price brought on by the import fee.

I submit that this list constitutes a conclusive case against the oil import fee.

STATEMENT OF DR. HENRY M. SCHULER, HOLDER OF DEWEY F. BARTLETT CHAIR IN ENERGY SECURITY STUDIES, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Senator Wallop. Dr. Schuler.

Dr. Schuler. Thank you, Mr. Chairman.

I listened with great interest to the discussion of the energy security benefits and how it might be possible to drive down the price of OPEC oil. I don't believe there are many people in this room who have a greater commitment to energy security, and I know there is nobody in this room who has spent more time in Tripoli and Tehran as a negotiator trying to keep the prices of that oil down. So, therefore, if I thought it was going to achieve those benefits, I would, obviously, support an oil import fee.

But like Dr. Greenspan, I do not think an oil import fee would achieve that result.

So I would like to address the question which I think is really fundamental. I think the administration had made it clear, and there are many in Congress who have made it clear, that they really view an oil import fee as a revenue raiser, either to reduce taxes or to reduce budget deficits.

And I think it is fallacious to assume that the OPEC producers are simply going to stand aside and allow the revenues on their depleting assets to be shifted from producers to consuming governments, particularly to that of the largest oil importer in the word.

So I would like to address these remarks to what OPEC could do about it were they not to like this situation.

And I would like to start by saying that of the 15.4 million barrels a day that the OECD nations imported in 1985, OPEC provided two-thirds. If you add Mexico, which has been a better member of OPEC than most formal members, you raise it to three-quarters of the oil imports of the industrial world came from OPEC in 1985.

Senator Bradley. Could you repeat that?

Dr. Schuler. Two-thirds of the——

Senator Bradley. The whole statistic.

Dr. Schuler. I take these statistics from the EIA's January 20 report which only covered the first two quarters, but I do not think there was a significant change over the full calendar year. Of the OECD's 15.4 million barrels per day of imports, two-thirds was from OPEC. If you add the 1½ million barrels a day of Mexican exports, you raise it to the order of magnitude of three-quarters of industrial world imports came from OPEC and collaborators.

Now if those countries were to reduce that supply, as Dr. Greenspan indicated, if the oil supply is reduced, obviously, prices will begin to climb. If those countries, OPEC, were able to reduce supplies, there is no place that it can be made up. There is no unutilized capacity in the United States; none in the Soviet Union; none in the People's Republic; none in the North Sea. And until a week ago, I thought there was 100,000 barrels a day in Alberta. But a conference we had on Monday indicated that there isn't even that much in Canada. So there is simply no unutilized capacity that can be brought on.

And this is not just a hypothetical argument. There is a very strong and growing element within OPEC which argues that the market preservation strategy is the wrong strategy, and that instead of preserving markets, they should preserve revenues, and be willing to be the residual supplier. But as volume goes down, stick up the price.

And it takes on a very strong political connotation because you have got Iran, Libya, and Algeria as the hawks on the one side and you have Saudi Arabia, Kuwait, and the others on the other side.

So it takes on this political connotation. The Iranian strategy cannot work, prices will not go up, as long as Saudi Arabia is willing to utilize its excess production capacity to keep prices down. Obviously, that is in Saudi Arabia's long-term global macroeconomic interest to keep the price down and preserve future markets. But it creates enormous immediate regional political problems for the Saudis. Iran is sitting on the Kuwaiti border. Egypt is suffering from riots. Egypt, which is the one Arab country that could offer a potential counter-weight to Iran, is suffering enormously from loss of oil revenues. Not only is the price of their oil declining, but tanker transit fees through the Suez Canal, repatriated earnings from the gulf, all those things are falling. So Saudi Arabia is under enormous political pressures.

And in my view, the imposition of a crude oil import fee would be the straw that broke the camel's back, because at that point we would be saying the U.S. consumer is prepared to pay more money for that oil, but we are going to take that additional revenue—we, the consuming government—rather than give it to the producers.

And there is a general view within OPEC that the Saudis are simply part of a conspiracy with the industrial world to drive the price of oil down. And were the Saudis to put up with this kind of a situation, they clearly would be accepting that that is precisely what they are doing, working with the industrial world. And there would be no intellectual basis for the Saudi argument that if we can reduce the price of oil to the consumer, it will increase demand.

Obviously, if we raise it up through a tax, that can't happen; there is no intellectual basis for the Saudi argument. At that point it seems to me they do what they did during the 1970's which is to say let us take a low profile, put our immediate political concerns above our long-term economic interest, and let the hawks make the running, and we know exactly what they want to do. Iran, Libya, and Algeria want to restore prices to $30 a barrel and raise them from there.

Thank you.

Senator WALLOP. Thank you, Dr. Schuler.

[The prepared written statement of Dr. Schuler follows:]

A Threshold Question about an Oil Import Fee

Testimony before

Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation

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Hearings on
Proposals to Tax Imported Oil

Submitted by
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February 21, 1986

I appreciate the opportunity to testify before this Committee in opposition to an oil import fee. Although I now hold the Dewey F. Bartlett Chair in Energy Security at Georgetown University's Center for Strategic and International Studies, the Center does not adopt institutional positions, and this testimony is based, in any event, upon my personal experience as a member of a team representing twenty-three major and independent oil companies in negotiations with OPEC over oil prices during the 1970s.

That very real practical experience seems to me especially relevant to the rising interest in using an oil import fee to raise revenues because it denies the current assumption that OPEC will stand idly by while the United States captures for itself a portion of the price paid by consumers. It simply flies in the face of logic and history to assume that the governments of exporting countries will dociley permit the government of the world's largest oil importer to enrich itself at their expense. In my judgment, their reaction will be like that of the Shah who was especially vociferous in insisting that "If any government is going to impose taxes on Iran's depleting asset, it is going to be mine!"

Therefore, while this Committee will receive a lot of valuable input about the impact of an oil import fee upon our own energy and fiscal policies, I would urge Congress first to consider carefully the impact upon OPEC's pricing policies. I believe that such careful consideration will reveal that OPEC currently suffers from a lack of self-interested discipline rather than from a lack of market power and that a U.S. effort to capture oil revenues is the one certain way to revive OPEC discipline.

I should perhaps add at this point that I would be prepared to reconsider my opposition and join the debate over the efficacy of an oil import fee for energy security at such time as I become convinced that OPEC's potential to wreak havoc on our economy is truly and permanently broken. But that is not my view at this time for the following reasons.

1. OPEC continues overwhelmingly to dominate that portion of the world's oil production which is available for export. During the first half of 1985 (the latest statistics available in the Energy Information Administration's January 20, 1986 edition of the "International Petroleum Statistics Report"), OPEC still provided two-thirds of the 15.4 million barrels per day (b/d) of oil imports which OECD members had to purchase to meet demand. If the 1.5 million b/d of OECD imports from Mexico are added in recognition of our neighbor's full cooperation with OPEC policies, the share of OECD imports provided by OPEC members and collaborators rises to over three-quarters. Other OPEC collaborators such as Egypt, Brunei and Malaysia provide significant additional volumes of OECD imports.

2. If OPEC members and collaborators were to reduce their exports, markets would inexorably tighten. Although there may be 10-12 million b/d of unutilized world oil production capacity which could be made available within thirty days, virtually all of it is controlled by OPEC members and

collaborators. There is no unutilized capacity in the North Sea, none in the USSR, none in the People's Republic of China, none in the United States and no more than 100,000 b/d in Canada. Nor would oil-in-storage alleviate an OPEC-induced shortage for long because OECD commercial inventories are at their lowest level since 1973, and government stocks are intended for use only in a dire emergency. It should also be noted that the vast volumes of unnecessary oil consumption which could be wrung quickly out of the system during the OPEC-induced shortages of the 1970s are no longer available thanks to mandatory automobile efficiency and investments made in conservation and fuel-switching when oil cost $40 per barrel and was expected to rise rapidly. In sum, the industrial world has no really viable option if OPEC members were to restrict the volume of oil which they made available for export.

3. The possibility of renewed OPEC pressure on oil exports is far from academic, for there is a strong - and growing - segment of the organization's membership which proposes to reduce production in order to restore earlier price levels. This group is led by Iran which formally disassociated itself from the first $5 price cut in March 1983 and has argued ever since for immediate restoration of prices in the $30-plus range even though it has of course been forced by market pressures to match OPEC cuts. It is important to recognize that while willingness to confront "Western imperialists" gives it strong political appeal, the Iranian strategy is not derived from revolutionary bombast. Teheran's strategy paper, a summary of which is attached courtesy

of *Petroleum Intelligence Weekly*, was prepared in fact by a Western-educated econometrician who was oil advisor to Minister Amouzegar during the Shah's reign. It is based on an entirely respectable recognition that all export prices would have to be cut to $15 per barrel or less for a significant period of time in order to increase current oil demand through shutting-in flowing non-OPEC production, reversing earlier price-induced (and now investment-sustained) fuel-switching and energy efficiency, and expanding economic growth. The consequences for revenue-pinched OPEC countries would be disastrous because price elasticities would certainly not act rapidly enough to permit exporters to make-up in volume what they lost in price. But, argued Iran, the slow working of price elasticities cuts both ways so, instead of preserving market share, OPEC should attempt to preserve revenues by compensating for reduced output through gradual price increases from the old $34 level. Again it should be noted that this emphasis on a formula approach to oil pricing is not out-of-line with mainline economic theory that peaks and troughs are the real barriers to sustained economic growth.

Although the Iranian analysis was not adopted as the basis for OPEC policy in 1983, subsequent market developments have tended to discredit the market-preservation strategy and to give credence to the revenue-preservation strategy, especially among those OPEC members who suffer most acutely from current revenue short-falls, those who lack the unutilized capacity required to take advantage of any expanded medium term demand and those who lack the oil reserves to benefit from long term market growth.

The combination of political and economic discontent with current OPEC policy has produced growing support for the Iranian position. In December 1984, Libya and Algeria joined Iran in rejecting the second Saudi-sponsored price reduction. At the July 1985 meeting of OPEC's Market Monitoring Committee, it was Iraq's oil minister who proposed the revenue-preservation strategy which was unanimously endorsed by that Committee, chaired by the oil minister of the UAE and including Ecuador as well as Iraq, Iran, Libya and Algeria. Although the MMC proposal was rejected by the full OPEC meeting a few days later, Saudi Arabia's subsequent declaration of a price war has prompted several previously passive OPEC members including, reportedly, Venezuela and Nigeria, to shift toward it.

4. Growing support for a revenue-preservation strategy involving restoration of $30 oil is doomed to failure so long as Saudi Arabia is willing to use its 4 million b/d of unutilized capacity to subvert any move by other exporters to tighten markets. Without denying the importance of reduced demand and expanded non-OPEC supply, we ignore the contribution of Saudi oil policy to current market softness at our peril. Responding at long last to repeated U.S. pleas for a long-term global view of oil markets, the Saudis began in 1980 to assert their full production potential on behalf of price restraint. After facilitating a massive inventory build and selling oil at $4 per barrel below market price during 1980 and 1981, the Saudis manipulated OPEC to adopt the first-ever OPEC price reduction of $5 per barrel in March 1983. Moreover, they repeatedly announced

thereafter that they would accept no nominal price increase for the foreseeable future, a policy which was designed to produce a real decline when the effect of inflation was included. As intended, this Saudi initiative foreclosed the Iranian alternative, and, whether intended or not, it also contributed enormously to further price weakness. Once prices started downwards, the slide gained momentum on both sides of oil balances. For exporters, lower prices meant the threat of even lower revenues so the most hard pressed had no political alternative but to attempt to gain immediate market share by discounting their oil, thereby adding to excess supplies. For importers, lower prices meant the promise of lower costs, so they had no commercial alternative but to abandon term contracts and run-down inventories, thereby reducing already inadequate demand.

While the Saudis' gigantic proven reserves create an obvious long-term global market justification for price restraint and a market preservation strategy, that logic was no less clear to Oil Minister Yamani during the 1970s when Saudi Arabia refused to exercise its oil clout to curb the oPEC hawks. That earlier timidity should be recognized as an unmistakable signal that the House of Saud will invariably sacrifice its long-term global economic interests when they come into conflict with immediate domestic or regional political threats. Failure to set priorities in this fashion would only accelerate dynastic shifts or even political upheaval.

5. The current Saudi oil policy of encouraging an OPEC price war without fulfilling the Kingdom's own revenue

requirements is exacerbating political threats at home and in the region. Not wishing to impose on the time of this committee with a fulsome catalogue of geopolitical developments, I will highlight just a few of the threats faced by Saudi Arabia.

o Iran, the principal regional power and champion of the alternative strategy, has threatened to respond to a price war with terrorism, subversion and sabotage. Perhaps the Iranian radicals are only bluffing, but their designs on the Kingdom's oil fields and holy places in not going to disappear.

o Egypt, the potential counter-weight to Iran, is threatened by radical fundamentalist unrest which finds fertile ground in an economic situation deteriorating from reduced oil sales, reduced tanker tolls from the Suez Canal, reduced Arab tourism and reduced remittances from workers in the Gulf.

o North Yemen, a buffer against the Soviet presence in South Yemen, is threatened by unemployed workers sent home by Saudi Arabia at a time when the newly-installed hard line Marxists in Aden are likely to become more aggressive.

o Radicalization of the Palestinian movement is a likely outcome of Arafat's vacillation, Hussein's rapprochement with Syria and the impending return of a Likud government in Israel.

o Despite extreme efforts to avoid a war of attrition, Iraq seems incapable of forcing Iran to the bargaining table so Saudi Arabia is faced with continuing demands on its revenues to finance the Iraqi war effort.

- The Saudi need to carve up a shrinking economic pie at home strains long-standing dynastic, provincial, social and confessional balances.
- The inadequacy of Saudi oil clout to win U.S. approval of Arab arms purchases and foreign policy goals tends to alienate the Saudi military and to raise concerns about American steadfastness in the event of armed aggression or internal upheaval.

In sum, the House of Saud is under growing pressure to reconsider the wisdom of a confrontational oil policy which immediately incurs a high profile and high risks but promises only meager long-term benefits.

6. Given the present Saudi political and economic climate, I strongly believe that U.S. imposition of an import fee would prompt the Saudis to relinquish leadership of OPEC to Iran, a development which would have enormous political/strategic repercussions as well as economic/commercial consequences. It seems to me inconceivable that the Saudis would continue accepting the already heavy political cost of declaring a price war on fellow producers while accomodating the wishes of the United States because

- Saudi Arabia would be said to aid and abet the transfer of oil revenues from producer governments to consumer governments.
- The hawks would charge that Saudi Arabia was not

only cooperating in a "U.S. plot" to destroy OPEC but also in a "Zionist plot" to impoverish the Arabs.

o Finally, the imposition of an oil import fee would eliminate whatever intellectual basis exists for the Saudi strategy. After all, if consumers do not enjoy lower crude oil prices, there is no reason to expect them to increase demand.

In conclusion, I would urge this Committee and Congress to give careful consideration to the threshold question of whether there is much prospect of enjoying a "free lunch", or, more precisely, a lunch paid for by OPEC. If imposition of an oil import fee prompts a basically pro-American and Islamic "modernist" monarchy in Saudi Arabia to relinquish control of OPEC to an unabashedly anti-American and Islamic "fundamentalist" revolution in Iran or - worse - if such imposition prompts the overthrow of the House of Saud, then we will indeed have paid an exceedingly high price for that lunch.

Iran Tells Opec: "Raise Prices, Lower Output"

Following are excerpts from a paper, "Views of the Iranian Delegation on Opec Long-Term Strategy," presented to the Nov. 15-16 ministerial Long-Term Strategy Committee in London, as obtained by PIW from a participant (p.2). The Executive Summary is almost verbatim, while the Critique section contains edited highlights.

EXECUTIVE SUMMARY

The need for an in-depth study and analysis of the many aspects of the complex issues involved in the formulation of a logical long-term pricing and production strategy for Opec was stressed repeatedly at the two-day meeting of the long-term strategy (LTS) experts committee held in London in September of this year.

Almost all delegates there questioned the validity of the main theme of the Secretariat's report which appeared to take "reactivation or increase of demand for Opec oil" as the main objective of the Opec's long-term strategy. Most delegates were of the opinion that the above theme does not constitute a proper objective for Opec LTS since increasing demand for Opec oil does not necessarily bring about "maximization of Opec revenues from Opec oil exports." The latter would constitute a certainly more plausible goal or objective for Opec LTS. It was then stated by several delegations that more careful study to determine the proper goals and objectives for Opec strategy was required.

At the experts' meeting in September, Iran reminded the committee that Opec pricing and production strategy objectives given in the Opec Solemn Declaration (following the Heads of States meeting in 1975) should be adopted as the main guidelines for Opec strategy, as they had already been adopted by heads of states. These stressed the goals of conservation of Opec petroleum resources and optimum use of their depletable resources for rapid economic development of Opec countries' economies.

Iran's Thesis

The Iranian delegate then briefly reviewed the results of two studies carried out by Iran in the past few years for determining an optimum Opec strategy. Its two long-term goals were: a) maximization of Opec countries' oil revenue stream over a long period, and b) rapid capital formation in other sectors of Opec countries' economies so as to generate new sources of income after depletion of oil reserves.

Iran's delegate stressed in September that the two distinct strategy options obtained from these Iranian studies (which were submitted in reports to the LTS committee of Feb.1980 in London and the Taif conference of May 1980 as well as to the Opec Energy & Development Seminar of 1980 in Vienna) from the main basis of Iran's thesis on Opec pricing and production strategy. They yield results which question the advisability for Opec of following any of the strategy options proposed in the Secretariat's report:

a) First option: If maximization of the present worth of Opec's revenue stream over a long period (e.g. 30 or 50 years) is taken as the main objective, then it can be shown that the optimum strategy for Opec would be to increase the price of Opec oil at an annual rate equal to the real rate of interest (which may come to 3%-8% per annum in present day terms).

b) Second Option: If rapid capital formation in non-oil sectors of Opec countries' economies is the main objective of Opec strategy, then it is shown that increasing the price of Opec oil up to a certain point will be useful for the economies of both consuming and producing countries, due to positive recycling effects of increased trade between Opec and oil importing countries.

The optimum price range, beyond which any further price increase would be harmful to both consumer and producer countries, can be determined if genuine cooperation between economic experts of Opec member countries (to reach agreement on basic objectives and assumptions) is achieved, followed by subsequent cooperation with consumer countries of both the industrialized and other third world countries.

Working Party

Iran would like this thesis to be evaluated by other Opec members, from whom it also invites contributions. Iran proposes that a serious effort be made by all member countries at the level of their top economic and technical experts on long-term pricing and production strategy for Opec, with a view to resolving the complex issues involved in the determination of an optimum Opec strategy. In order to establish a scientific and logical basis for reaching agreement on some of the controversial issues involved, we propose that a semi-permanent working party of top economic and technical experts of all member countries be assigned initially for a period of 3-4 months to work in Opec headquarters in Vienna, or any other mutually agreed venue, to carefully study the problem and report findings to the LTS experts committee. If the experts committee approves them, these findings can be submitted through the LTS ministerial committee to the Conference. This will result, hopefully, in preparation of a long-term guideline or formula to be given to the Economic Commission Board for their deliberations in making short-term pricing and production recommendations to the Conference.

CRITIQUE OF SECRETARIAT REPORT

The Secretariat's LTS report reviews the evolution of the oil price structure in the last decade and the reasons for the demand decline for Opec oil in this period. It concentrates on "ways and means to increase demand for Opec oil" as the main theme of the report and suggests four different strategy options for Opec pricing policies in the future to be considered by the LTS experts committee.

Three of the four options or scenarios suggested for Opec pricing policy advocate various formulae for freezing or even reducing the nominal price of oil, or other ways of gradually reducing oil prices in real terms for an indefinite period, until the world demand for Opec oil reaches a predetermined desirable level. This is not at all surprising since the Secretariat's analysis is based on the premise that the main objective of Opec strategy should be to "increase world demand for Opec oil," a goal which cannot be achieved except by continuous price decline, either in nominal or real terms.

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Strategic Objectives

All delegations except Saudi Arabia questioned the validity of this objective for Opec strategy. They argued that the mere increase in Opec's market share does not necessarily bring about maximization of Opec revenues, which constitutes a more plausible and useful objective. Apparently, the Secretariat's choice of "increasing the demand for Opec oil" for the theme of Opec strategy is due to the fear that any decline in demand for Opec oil, or a gradual decrease in Opec's market share (such as has been witnessed in recent years) would result in a gradual decline in Opec export revenues.

We believe that nothing is wrong with a gradual decline in the demand for Opec oil if it is accompanied by an equal or faster rate of price rise so that export revenues do not decline.

A glance at the evolution of the price and demand levels for Opec oil in the last six years proves this point, since the value of Opec's present reduced production of about 17-million b/d at $29 a barrel is certainly much more compared with the value of its production of some 30-million b/d at a price of $12.70 in 1978, just before the price adjustments of 1979-80. The value of Opec production has increased from some $390-million a day to about $500-million a day despite a definite decrease in demand for Opec oil.

Price Freeze No Remedy

The following simple facts demonstrate that freezing or reducing Opec oil prices in the next few years, as a remedy for present Opec problems, would not represent sound policy and would be detrimental to long-term interests of Opec countries:

1. The Opec Secretariat observes several times in its report that the $5 a barrel reduction in Opec's "marker" crude oil price in March 1983, has not provided consumers with the expected incentive that would reactivate demand for Opec oil—because treasuries in oil consuming countries have, in most cases, captured for their government the benefit of the price cut through taxation and improvements in the balances of payments. Hence it is not clear why the Secretariat, despite its own assessment that governments and oil companies have prevented the price cut being transmitted to the final consumer, still advocates or even considers further reduction of Opec oil prices, be it in nominal or real terms.

One obvious lesson from events of the past eight months would be to reverse events by immediately restoring the Opec marker crude price to the former $34 a barrel. This would end the senseless transfer from the poor nations of Opec of some $25-billion a year of badly needed development funds.

What is obvious is that any Opec price cut which does not boost demand would only cause excess desire in each of the producing countries to increase their individual production and maintain export revenue at levels planned before the price cut.

The higher propensity to export caused by price reduction can only lead to creation of a surplus which will cause further weakening of the market and more downward pressure on Opec prices. this further increases the export propensity and leads to a chain reaction ending in a serious market glut.

Price Elasticity

2. It is a universally accepted fact that the long-term price elasticity of demand for oil is less than unity. This means that even if a price reduction were freely transmitted to the final consumer, the percentage rise in demand would be smaller than the price reduction. If we take price elasticity as 40% (estimated independently by the World Bank and accepted by the Opec Secretariat), the 17% decrease in the Opec oil price adopted by the March 1983 Conference could cause an increase in demand for Opec oil, in the long term, of about 7%. This would reduce export revenues about 10%, thus applying pressure on each Opec oil producer to increase accepted production quotas by 10% to keep previously established levels of export revenue intact. This would further weaken the market for Opec oil.

3. Accepting that at a certain price level for oil, price elasticity may exceed unity, the economics of depletable resources shows that maximization of revenue and conservation can best be achieved by a gradual increase in prices at an annual rate equal to the rate of interest.

4. The sharp price jumps of 1979-80 which were damaging to both consumers and in the long term to producers. were themselves the result of earlier decisions to freeze prices in 1977-78 which Iran warned would have unhappy consequences. Those in Opec who insisted on imposing the price freeze of 1977-78 (and subsequently repented its unhappy consequences) should in retrospect have learnt the lesson that if they had not yielded to the insistence of the industrialized countries of the West, but had acted more responsibly by accepting a reasonable rate of gradual price increase, they would have witnessed a much healthier evolution of Opec oil prices. This would probably have avoided the price jump of 1979-80 as well as the Opec price cut of 1983. A uniform annual rate of increase of Opec oil prices of about 21% during the six-year period 1977-82 would have taken us gradually from $12.70 a barrel to $34 a barrel.

Substitution

5. One argument put forward by the Secretariat for a gradual lowering of the real price of Opec oil is that this would discourage new investments in alternative energy sources (such as non-Opec shut-in reserves, synthetic fuels etc.), and also slow down market penetration of developed sources such as coal. A counter-argument put forward by many Opec members is that this investment is spurred more by desire for national energy resources and for reduced Opec dependence than by economic incentives. Thus a small change in prices won't necessarily alter greatly investment policies in industrialized countries or LDCs.

6. The argument that Opec must maintain market share in order to continue exercising influence in the long term is put forward by those who assert that without this Opec would be vulnerable to competition from different and new sources of energy. But the size of remaining reserves may, in fact, be a more important deterrent to those considering investments in substitutes for Opec oil.

Thus we see that there are two sides to every coin. Contrary to the conclusions and unwarranted concern expressed in the Opec Secretariat's report about the negative effects of Opec price increases, we find that there are indeed certain positive effects from Opec price increases which should not be overlooked in a serious in-depth study of the Opec long-term strategy issues.

STATEMENT OF DR. S. FRED SINGER, VISITING EMINENT SCHOLAR, GEORGE MASON UNIVERSITY, FAIRFAX, VA

Senator WALLOP. Dr. Singer.

Dr. SINGER. Thank you, Mr. Chairman.

I want to give a three-point economic rationale in support of the Wallop-Bentsen bill, S. 1997, which proposes a floating—that is, a variable—import fee; it is equal to the difference between a reference price of about $22 and the world price whenever it is lower.

Now this variable import fee is a temporary fee. It goes into effect only when the world price is pushed below this reference price. It, therefore, does not raise costs; it stabilizes the price at the reference level. And its major purpose, as I see it, is not a tax, but for conservation.

Please try not to think of it as a tax. And I will try not to use that word, if I can help it.

I do not support, I had better state it again, a straight oil tariff, which would raise energy costs, which would raise revenues, which would be a tax. I object to that.

And most of the objections that I have heard this morning from various witnesses address this latter tax, this straight tariff. I think we should be talking here about the variable import fee, which is not designed to raise revenues, but simply stabilizes the price.

Now it is important that this reference price be set properly. Because if you set it too high, you turn this fee into a tax. Obviously, if you set the reference price at about $30, the fee becomes a tax.

In my view, the correct price in 1986 is $22. I arrive at this by constructing a model, a mathematical model, whose major assumption is that the price, the world price, is set by Saudi Arabia in such a way as to maximize their profits. It assumes that they act rationally over the long term. It assumes that prices may fluctuate above and below, but in the long term they will try to achieve a price which maximizes their profits.

I believe that this model has been well tested in the last few years. The model was published several years ago. It predicts a price of $18 in 1982 dollars for 1986, and that is $22 in 1986 dollars.

If you want to look at the backup, it is given in the written testimony. I will not repeat it here. The base case is curve 4 out of the various curves that are plotted there. The present price, which is $12 or thereabouts, I view as an overreaction of the market; I think it is temporary and will soon increase.

Again, the variable import fee is not a tax, and, therefore, of course, it is revenue neutral. And it is not regressive. I think all these discussions are irrelevant when we discuss the stabilizing function of this fee.

The next point that I want to make is that this variable import fee should be looked at as a countervailing tariff of the kind that we would use now to fight dumping. We do have antidumping legislation on our books administered by the Department of the Treasury.

Now normally when we think of dumping, we would think of someone selling below his cost in certain markets in order to squeeze out competition. What is happening now is very similar to that. Saudi Arabia is selling below their optimum price, below their best economic price, in order to squeeze out competition.

They have announced that they have started a price war. In fact, in addition to doubling their production, they have also sold off their stockpiled oil, dumping it on the market. So it has all of the aspects of dumping. And I think a countervailing tariff is the way to meet this problem.

The third point I would like to make is that the main purpose of this variable import fee should be conservation: not the raising of revenues. And I am not speaking only of conservation for consumers. I think that is obvious. We all know how that works.

I would like to talk particularly about conservation for producers. It has been mentioned several times this morning. But let me emphasize that if the price drops for a short time—and I am speaking of several weeks—below this reference price, this will cause many wells to shut in prematurely and be plugged.

There are about half a million stripper wells out there that supply 12 percent of U.S. production. The rate of abandonment, of premature abandonment, is going up drastically. It has doubled between 1980 and 1984. It is going to skyrocket this year as prices really drop.

Once a well is plugged, it will never be reopened, even if the price rebounds. It is just too expensive to reopen a plugged well. That oil is permanently lost, and I would maintain that this goes against the principles of conservation, of resource conservation.

Because of all the things I have said here, I feel there is no need for exemptions to special user groups, and there certainly is no need to exempt Western Hemisphere producers. It would not only make everything very complicated, but it is not necessary.

The issue of Mexico has been mentioned several times. I think it is a red herring. Certainly, if we import less oil as a result of stabilizing the price, this would put pressure on the world price, and it will go down. And I think we all agree that it is a good thing for the world price to go down.

But Mexico will not get hurt any worse, whether we put on this variable import fee, or whether we simply conserve and use less oil. Oil conservation of various sorts will drive the world price down, and I think that is what we should be aiming for.

Let me summarize. We don't have a free market in oil in the world. We have price manipulation primarily by Saudi Arabia. They can drive the price up or down as they wish by adjusting their production. They can jiggle the price in a sawtooth fashion and cause havoc with U.S. oil producers and with U.S. oil conservation.

It is in the national interest, therefore—Senator Boren has made this point—that we protect ourselves against this. And that is why I would support a variable import fee.

Thank you.

Senator WALLOP. Thank you, Dr. Singer.

[The prepared written statement of Dr. Singer follows:]

Testimony on Energy Policy and Energy Taxes
to the Senate Finance Committee

February 27, 1986

Prof. S. Fred Singer

The drop in world oil prices represents a unique opportunity for the United States to increase the prosperity of its citizens. The recommended policy tool is double-barreled:

(1) An oil import fee to promote conservation and not to raise revenues.

(2) A gasoline tax that is not a tax but a user fee.

This policy is fair to consumers and energy producers and to the different regions of the country. It should satisfy those who want to:

Advance energy conservation

Increase national security

Cut budget deficits

Not increase federal taxes

Not abridge free trade

(1) Variable Import Fee (VIF)

The VIF adds to the world price (WP) to achieve a target price (TP). The target price is the "correct" economic price, now about $22 a barrel ($18 in 1982 dollars, see Appendix 1).

The VIF:

goes into effect when the WP is driven below the TP, whether by manipulation of supply or by dumping of inventories.

is therefore analogous to a "countervailing tariff" authorized by existing anti-dumping legislation.

is strictly temporary and disappears when the WP recovers to the TP.

is not directed against OPEC, Mexico, or any specific oil exporter.

is not an extra burden on consumers, who will see a stable oil price instead of large fluctuations that can misdirect their ongoing conservation efforts.

The VIF:

is not a tax designed to raise revenues.

is designed to achieve resource conservation.

In 1984, the U.S. had 452,543 stripper wells in operation, each producing less than 10 barrels a day, averaging 2.8 b/d. Nevertheless, they furnished 1.27 mbd, or 12% of domestic production.

In 1984 nearly 15,000 oil wells were abandoned, double the number of 1980. If prices fall below $20, the number of stripper wells abandoned will increase dramatically. Once plugged, they will not be put back into production — even when the price recovers — and the resource will be permanently lost.

Below $20, other production will become uneconomic, for example much of the current tertiary recovery. At $12 a barrel, Alaskan oil will stop flowing — again with great resource losses when restarted after the price recovers.

Even a temporary drop in oil prices, lasting a few weeks or months can damage not only oil conservation, but also gas and coal. It will also give wrong signals and upset consumer conservation efforts — from home insulation and fuel-efficient cars to coal-conversion projects designed to back out oil.

There are small problems with a VIF (as with any administrative measure); how to deal with quality differentials, product imports, petrochemicals exports, etc. These problems I judge to be manageable.

But there should be no exceptions to an import fee: not to any country (even Mexico and Canada), nor to any importer (no matter how deserving).

A detailed discussion of a VIF and arguments against straight oil tariffs are given in: "Restrictions on Oil Imports?" in Free Market Energy (S. F. Singer, ed.) Universe Books (New York, 1984). See Appendix 2.

A MOTOR FUELS USER FEE (MFUF)

A MFUF (a.k.a.gasoline tax)

is a user fee to pay for the nearly $50 billion of annual highway costs now supported by general state taxes and bonds. (The other $20 billion of highway costs are paid for by the 9 cents federal and the (average) 14 cents state gasoline tax.)

is analogous to tolls on roads, bridges and tunnels but easier to collect

if collected by the States, then States can cut other taxes, including sales and income taxes

if collected by the federal government and passed through to the states, then the federal deficit can be cut by eliminating at the same time federal subsidy programs targeted to the states

reduces vehicle miles traveled by 10%, oil imports by 30%, OPEC sales by 10%, and therefore world price

reduces accidents and congestion, worth at least $60 billion a year; also pollution, noise, stress

encourages conservation, mass transit use, and improves urban quality of life

eliminates the need for coercive conservation measures: federal vs state speed limits, gas guzzler taxes, mandatory fuel-efficiency standards (CAFE)

is not regressive

A fuller description is given in recent editorial essays and letters (see Appendix 3).

Summary

A VIF/MFUF policy is economically equitable

- to consumers and energy producers
- to income groups and regions of the U.S.
- advances conservation of both resource production and consumption

There is no need for:

- exemptions or special arrangements
- a general energy consumption tax (BTU tax)
- value-added tax

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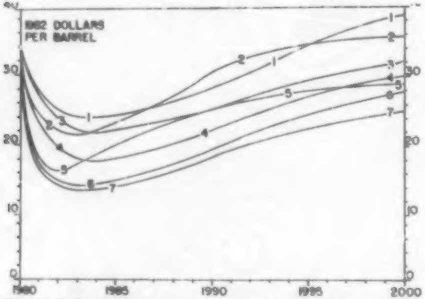

Figure 2. Optimal price path for OPEC core (calculated under assumptions of appendix cited in Reference 2).

APPENDIX 2: THE OPTIMAL OIL PRICE FOR THE OPEC CORE[17]

A known setting of the world petroleum market (23) considers the OPEC group as a price-leading monopolist facing a normal demand function and competitive supply from alternative sources. Within this setting, the monopolist's problem is to fix a set of prices that maximizes the sum of his discounted stream of profits over the foreseeable future.

The OPEC-as-monopolist model does not represent certain important features of the oil group. For example, it ignores conflicts of interest which obviously exist among the member countries. Attempts have also been made to represent OPEC by oligopolistic models (24, 24a, 25). However, equilibrium solutions do not necessarily exist, and when they do, they are not easily computed. Moreover, observations of the OPEC decision-making process indicate the dominant position of Saudi Arabia within the group. Hence, the most appropriate setting is still a monopolistic model, but with a "core" of Saudi Arabia and some of its followers, such as the United Arab Emirates, as the price leader, occasionally joined by Kuwait or Libya. Other OPEC members are then considered part of the competitive supply, along with non-OPEC producers. This simple quasi-monopolistic "core" model is preferable to the oligopolistic framework.

The monopolistic model has, nevertheless, certain deficiencies. The assumption of a rational producer who maximizes his flow of profits over a long period of time implies his prior knowledge of future demand, alternative supply, and his own cost function. Such knowledge is almost nonexistent in actual situations or at least is highly imprecise. Therefore, for practical purposes, from the viewpoint of the monopolist, an optimal pricing *strategy* is to be preferred to the computation of the optimal price (e.g. 26). Thus, we are not suggesting that the OPEC hard core has actually computed an optimal set of future prices and has decided to act accordingly. Rather, we argue that the present model allows us to analyze the various effects of exogenous variables on the optimal price. For example, we would be able to indicate how the world price of oil is affected by changes in world demand, non-OPEC supply, and perceived discount rate. Similarly, we can analyze possible effects of large oil discoveries, of the occurrence of a backstop technology, of an alternative energy source, of a tariff on oil imports or a possible long-term embargo of oil exports, and of the size of the OPEC core (i.e. those countries that actually determine the world price by their own production decisions).

In the quasi-monopolist model elaborated here, a "core" of OPEC countries, Saudi Arabia, and other Arabian producers, act as the residual suppliers of oil; i.e. they supply the difference $(D_t - S_t)$ between world demand D_t and the supply S_t of the rest of the world's oil producers. These producers, whether members of OPEC or nonmembers, are assumed to be "price takers" who sell all they can produce at the going price P_t. The core is made up of countries with large oil reserves and small populations and is therefore more concerned with a long-term market for their oil rather than with satisfying short-term revenue needs.

The core, acting as a quasi-monopolist, should try to maximize its stream of net revenues over the foreseeable future, discounted to the present (Equation 1),

$$\text{Max} \sum_{t=1}^{T} (D_t - S_t)(P_t - C_t)(1+\rho)^{-t}. \qquad 1.$$

$C_t = C_0\, e^{bt}$ is the unit production cost of the core, assumed to grow exponentially with time as low-cost oil supplies are depleted. This is roughly equivalent to modeling C as a function of the remaining reserves—and about as imprecise. The letter ρ is the discount rate as seen by the core, and assumed constant over time.

The time horizon T, if it represented the exact exhaustion time, depends on the production schedule. In a more correct setting, T should also be considered a control variable (54). For our computations we have, however, chosen a value of T large enough such that high extraction costs beyond it, and a reasonable positive discount rate, ensure that the more distant future will have little impact on the optimal prices for the relevant time span.

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[17] This section was coauthored by Alexander Lebanon and S. Fred Singer.

The actual demand for oil, D_t, and the competitive supply of oil, S_t, are assumed to adjust slowly to some long-run values D_t^* and S_t^* (Equations 2, 3), i.e.

$$(D_t - D_{t-1}) = \lambda(D_t^* - D_{t-1}). \qquad 2.$$

$$(S_t - S_{t-1}) = \mu(S_t^* - S_{t-1}). \qquad 3.$$

The reciprocals, λ^{-1} and μ^{-1}, of the adjustment parameters λ and μ are the adjustment times (measured in years).

Such dynamic demand formulations are widely used, especially when related to the utilization of durable appliances or to some habit-forming trend, such as consumption of energy (55). With such a formulation the quantity demanded adjusts gradually to a sudden change in prices. The competitive supply is formulated as an adjustment process as well. Oil production necessitates quite a long lead time, and the effects of a sudden change in price will be distributed over a long time period.

The long-run demand and supply functions themselves are assumed linear with prices and shifting over time (Equations 4, 5), i.e.

$$D_t^* = (a_0 - b_0 P_t)(1+\delta)^t; \quad b_0 > 0, \delta > 0. \qquad 4.$$

$$S_t^* = (a_1 + b_1 P_t)(1-\sigma)^t; \quad b_1 > 0, \sigma > 0. \qquad 5.$$

Linear formulations are not only simple to deal with, but their elasticities also increase with price. This characteristic is an adequate description of the demand and supply for oil. The shift parameter δ represents the effects of a growing income on demand. The competitive supply curve is shifting to the left and higher over time because of resource exhaustion and increasing production costs, according to parameter σ. The demand and supply functions (Equations 6, 7) are then evaluated as:

$$D_t = \lambda(a_0 - b_0 P_t)(1+\delta)^t + (1-\lambda)D_{t-1}. \qquad 6.$$

$$S_t = \mu(a_1 + b_1 P_t)(1-\sigma)^t + (1-\mu)S_{t-1}. \qquad 7.$$

Long-run elasticities of demand and supply (Equations 8, 9) are derived as:

$$\varepsilon = b_0 P(a_0 - b_0 P)^{-1}. \qquad 8.$$

$$\eta = b_1 P(a_1 + b_1 P)^{-1}. \qquad 9.$$

Short-run elasticities are $\lambda\varepsilon$ and $\mu\eta$, respectively.

The solution to the optimal control theory problem (Equation 1) can be represented, if $\mu = \lambda$, in a recursive form (Equation 10):

$$P_t/E_t = (1+\rho)(1-\lambda)^{-1}[(1-\lambda E_{t-1})(P_{t-1}/E_{t-1}) + \lambda C_{t-1}] \qquad 10.$$

where E_t^{-1} is the long-run price elasticity of the net demand for oil (Equation 11).

$$E_t = [b_0(1+\delta)^t + b_1(1-\sigma)^t](D_t - S_t)^{-1}P_t. \qquad 11.$$

Thus the optimal price will be a distributed-lags function of past production costs. The coefficients of this function will depend on the demand and the competitive supply function, as well as the monopolist's discount rate.

Using the solution (Equation 10), one can compute recursively the path of optimal prices given some starting price P_0, deduced from the initial condition D_0 and S_0.

For illustrative purposes only, we present the result of one simulation run. We have chosen, for this run, parameter values similar to those used by Pindyck (24, 24a), who solved a similar problem using an elaborate computer algorithm. The 1974 world production of oil was 21.17 billion barrels. Of this, the hard core of OPEC (Saudi Arabia, the United Arab Emirates, and Qatar) produced 3.89 billion barrels in 1974. The production cost in the core countries is taken at 50 cents per barrel in 1974 and assumed to grow at an average rate of three percent per year. The price elasticity of the world demand for oil is assumed at −0.15 at the base-price value. The price elasticity of the competitive supply is assumed to be 0.30 at the base-price value. The total world demand for oil is assumed to grow at 1.5% per year owing to income effects. The competitive supply is falling by about 2.5% per year as a result of exhaustion of their resources. The monopolist discount rate is 0.05. Finally, the adjustment parameter is set at 0.125; thus, a sudden change in price will complete its effect on the actual supply and demand after about eight years. The functional form of the demand and supply functions (Equations 12, 13) is given by

$$D_t = 0.125(22 - 0.273P_t)1.015^t + 0.875D_{t-1}. \qquad 12.$$

$$S_t = 0.125(16 + 0.445P_t)0.975^t + 0.875S_{t-1}. \qquad 13.$$

Results for the base case are given in Figure 6. The 1974 (optimum) price is \$12, very close to the official OPEC price. The optimum price declines slowly reaching a minimum value (in 1974 dollars) about 30% less in 1982. The decline time constant is determined by the value of λ, and the depth by the demand and supply elasticities. The price rises gradually at a rate determined by the assumed parameters, including the growth rate of the production cost for the core.

The actual price departed greatly from the optimum, beginning in 1979–1980. We therefore calculated the price path, beginning in 1980, that would

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be "optimal," i.e. maximize discounted profits for the OPEC core as of 1980.[10] We found that the price path depends very strongly on demand elasticity, ε, supply elasticity, η, adjustment parameter, λ, and the discount rate, ρ. The demand shift parameter (for income) δ, the supply shift parameter (for exhaustion) σ, and cost parameter k influenced optimum prices only much further out. Some results are shown in Figure 10. The major conclusions are the following:

1. Under a wide range of demand and supply elasticities, the OPEC core (mainly Saudi Arabia) should increase its production quickly to achieve a price of about $18. Even though it may cause the core countries external political problems (which are outside the scope of this model), such a policy would maximize their stream of profits as of 1980 (or 1982). It is a suboptimal solution, since the core would have received a greater stream of profits if it had followed the price pattern shown in Figure 6, i.e. without the 1979 price increase.
2. The discount rate perceived by the OPEC core affects production decisions in an important way and thereby the world price. A high discount rate means that little value is put on future income (as against present) and corresponds to fear of loss of the oil income, perhaps due to political factors.
3. Variations in the demand-shift parametet are hardly important, but the supply-shift parameter and the OPEC core production cost play a significant role in the world price after 1990-2000.

Derivation of the monopolist optimal price (Equation 10)

The monopolist is assumed to maximize his present value of a stream of net profits over T time periods (Equation 14):

$$V = \sum_{t=1}^{T} V_t = \sum_{t=1}^{T} (1+\rho)^{-t}(P_t - C_t)(D_t - S_t). \qquad 14.$$

Assuming adjustment in demand and in competitive supply with the same adjustment parameter, i.e. $\mu = \lambda$, one can write the net demand at some time t in terms of a moving average of the long-run demand and supply (Equation 15):

$$D_t - S_t = (1-\lambda)^t(D_0 - S_0) + \lambda \sum_{\tau=1}^{t} (1-\lambda)^{t-\tau}(D_\tau^* - S_\tau^*). \qquad 15.$$

Assuming that the production costs C_t are independent of the production level $D_t - S_t$ and that they are known in advance, then V_t is a predetermined function of all of the past, and of the current, prices $P_1, P_2, \ldots P_t$. V_t does not, however, depend on future prices $P_{t+1}, \ldots P_T$. Thus, given that a set of optimal prices $P_1^*, \ldots P_{T-1}^*$ has been found, then the optimal price P_T^* in the last period, conditional on those earlier prices is uniquely determined by solving Equation 16:

$$\delta V_T/\delta P_T = 0. \qquad 16$$

By backward induction, given the set $P_1^*, \ldots P_{t-1}^*$, the optimal price P_t^* is found by solving Equation 17:

$$\sum_{\tau=t}^{T} \delta V_\tau/\delta P_t = 0. \qquad 17.$$

Now:

$$\sum_{\tau=t}^{T} \frac{\delta V_\tau}{\delta P_t} = (1+\rho)^{-t}(D_t - S_t) + \sum_{\tau=t}^{T} (1+\rho)^{-\tau}(P_\tau - C_\tau)\frac{\delta(D_\tau - S_\tau)}{\delta P_t} = 0. \qquad 18$$

Therefore:

$$(1+\rho)^{-t}(D_t - S_t) - \lambda[b_d(1+\delta)^t + b_s(1-\sigma)^t] \times \sum_{\tau=t}^{T} (1+\rho)^{-\tau}(1-\lambda)^{\tau-t}(P_\tau - C_\tau) = 0 \qquad 19.$$

Similarly for $t-1$:

$$(1+\rho)^{-t+1}(D_{t-1} - S_{t-1}) - \lambda[b_d(1+\delta)^{t-1} + b_s(1-\sigma)^{t-1}] \times \sum_{\tau=t-1}^{T} (1+\rho)^{-\tau}(1-\lambda)^{\tau-t+1}(P_\tau - C_\tau) = 0. \qquad 20$$

The summation in Equation 19 cancels if we subtract Equation 20 from Equation 19. We first multiply Equation 19 by:

$$\frac{(1+\rho)^t(1-\lambda)}{b_d(1+\delta)^t + b_s(1-\sigma)^t} \neq 0. \qquad 21.$$

Then we multiply Equation 20 by:

$$\frac{(1+\rho)^t}{b_d(1+\delta)^{t-1} + b_s(1-\sigma)^{t-1}} \neq 0. \qquad 22.$$

Subtracting:

$$\frac{(1-\lambda)(D_t - S_t)}{b_d(1+\delta)^t + b_s(1-\sigma)^t} - \frac{(1+\rho)(D_{t-1} - S_{t-1})}{b_d(1+\delta)^{t-1} + b_s(1-\sigma)^{t-1}} + (1+\rho)\lambda(P_{t-1} - C_{t-1}) = 0. \qquad 23.$$

The solution (Equation 10) follows immediately if we define E_t through Equation 11.

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[10] These calculations were carried out by Mr. David Sappington.

THE WALL STREET JOURNAL, FRIDAY, JANUARY 18, 1985

If Oil Price Dives, Leap In With Fee

By S. Fred Singer

What might have seemed sheer speculation in these columns during the height of the "oil crisis" in 1980 may be coming to pass. The Saudi oil minister, Sheik Ahmed Zaki Yamani, has now warned publicly of a possible "price war," which could drive oil prices down toward pre-1974 levels. How low could that price become, how long would it remain at the bottom, and how and why would a price war happen? How will it affect the U.S. economy, the ongoing conservation effort and U.S. energy investments? What, if anything, should the government do during an oil producers' price war?

The possibility of a price war derives from the continuing oil glut, a feature of the world oil market since about 1981. The glut, in turn, is caused by the efforts of the Organization of Petroleum Exporting Countries to maintain the world oil price at the unrealistically high level of $29 a barrel. OPEC hopes to do this by acting as a cartel, i.e., by mutually agreeing to limit production to make oil scarce. But the scheme is not likely to work while excess capacity almost equals OPEC's present output. It is in the interest of each cartel member to cheat by selling additional oil "under the table" to increase its share of the market and increase badly needed revenues. As such selling proliferates and cartel discipline breaks down, the price must fall.

Plan Isn't Working

So far, the brunt of the production cutback has been assumed by Saudi Arabia; starting in 1981 it reduced production from over 10 million barrels per day (mbd) to nearly three mbd, in a futile and mistaken effort to defend the then price level of $34. It can be demonstrated by calculation that the optimum price level for Saudi Arabia, i.e., the one that leads to the highest long-term profit stream, is about $20 – well below the current price. As the holder of the largest oil reserves, the Saudis should nudge the price down to this level to protect their future market.

For internal political reasons, the Saudis avoid lowering the nominal price but instead let it erode by inflation; unfortunately for them, this plan is not working, since the dollar has become stronger and inflation weaker. They also have a severe external political problem: their OPEC fellows, most of whom will soon be running out of oil, would much rather keep up the price a little longer by having Saudi Arabia reduce production further. And some of them, like Iraq and Iran, are militarily strong and quite close by.

With these conflicting goals within OPEC the situation could become unstable. Expecting further price decreases, producers would sell as much of their oil as possible at the current higher price, and holders of stockpiles would dump them on the market. But these extra supplies would bring down the price quickly and thus produce a self-fulfilling prophecy.

The driving force is the desire for profits. To give rough numbers: Holders of some 500 million barrel inventories (for example, many oil companies) would make $5 billion if they could sell quickly and buy back at $10 less per barrel. This collapse scenario is the mirror image of the 1979 events when expectations of oil shortages, fostered largely by pronouncements of the Carter White House, led to panic buying and hoarding, and to a rapidly rising price.

A price collapse either can be kicked off spontaneously, going well below $20 as sellers flood the market – or, as the Saudis have threatened to do, it can be set off deliberately. The Saudis' purpose is to scare OPEC members and get them to stick to agreed-to production quotas or else be undersold. The threat also is designed to keep non-OPEC producers (principally Britain, Norway, Mexico and the U.S.S.R.) from lowering contract prices. Yet another price-war trigger could be the sudden appearance of additional supplies – for example, Iraqi oil that has been held off the market by the Iraq-Iran conflict.

> *OPEC, especially Saudi Arabia, has enough unused production capacity of low-cost oil to drive the price down to $10 to $12 a barrel, at least for several weeks.*

The price collapse may take the following form. OPEC, especially Saudi Arabia, has enough unused production capacity of low-cost oil to drive the price down to $10 to $12 a barrel, at least for several weeks. One arrives at these numbers by estimating how much oil is available at each production cost level, i.e., by estimating a world supply curve. (The supply curve incorporates a hotelling factor that accounts for the opportunity to invest revenues now vs. selling the oil at a future higher price.) The price is then set by its intersection with a world demand curve in a truly competitive market where all low-cost oil wells produce to maximum capacity. The duration of such a collapse should be short, perhaps commensurate with a typical oil-shipping time of two to four weeks. Once oil producers found themselves caught up in a price war, they would resolve to observe strictly their production quotas and the price would rise to near its present level. Of course, if the producers act quickly, the price might not drop all the way to the theoretical $10 level.

The effects of even a brief price collapse could be far-reaching. It would temporarily put out of business oil wells with a marginal production cost greater than about $10 a barrel; this includes most U.S., including Alaskan, oil and also much OPEC oil. Producers of competitive fuels – coal and gas, usually sold under long-term contracts – would experience some difficult moments. Consumers probably would not benefit from the lower world oil price, because competition might not have enough time to work its way through the system. But even a short-lived episode could hurt the continuing conservation effort and certainly give the wrong long-range signals. Consumers should be aware that the price of oil will rise eventually, and certainly be higher than the present price after the year 2000 – as low-cost oil gradually becomes depleted, even in Arabia.

Under these circumstances it makes sense for the U.S. (and other oil-importing nations) to take appropriate countermeasures. The preferred action is a variable import fee (VIF) to keep the price of imported oil at some fixed level during the price-collapse episode. Such a fee, applied on a temporary basis, would also stabilize domestic prices for all fuels and keep the situation unchanged for domestic producers and consumers – as if the price collapse had not occurred.

Some care has to be taken in applying a VIF, so as not to discourage competition among oil buyers to get the lowest price on the world market. Such procedures are not too difficult to work out. For example, the VIF could be set periodically as the difference between a fixed target price (set by Congress, at say, $25) and a world averaged spot market price. Oil importers would profit if they could purchase at less than the average price.

It is quite appropriate to think of the VIF as a countervailing tariff applied against the dumping of a commodity – a well-accepted legal procedure. The overall effect of the VIF would be to transfer profits from foreign oil producers and oil brokers to the U.S. Treasury, without raising consumer prices. It would also protect the investments of thousands of energy producers (some 15,000 oil producers in the U.S.) and Treasury revenues derived from the windfall tax (which would cease if the domestic price drops below about $16).

Most Difficult Problem

It is appropriate for all industrialized nations (most of whom are represented in the International Energy Agency) to take coordinated action on individual national import fees to avoid competition in exported goods based on energy price differentials. Further, such action by the IEA would ensure that the world consumption of oil not increase even if the price collapses. Of course, oil companies around the world would take advantage of bargain spot prices to replenish inventories, and take a profit later when oil prices recover. But their profit comes out of the pocket of oil producers, not consumers.

By far the most difficult problem will be to convince consumers that the VIF is not a tariff, is strictly temporary, and will lead to lower prices of world oil in the medium and long run by constraining oil demand through conservation. It is not difficult to see that if the Treasury refunds VIF revenues via a tax reduction, the average oil consumer qua taxpayer will also derive short-term benefits from an oil producers' price war.

Mr. Singer is a visiting professor at George Mason University in Virginia. His latest book is "Free Market Energy," published last year by Universe Books.

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THE WALL STREET JOURNAL FRIDAY, JULY 5, 1985

Scorecard for the OPEC Meeting

By S. Fred Singer

OPEC's meeting in Vienna starting today may become the most momentous in the organization's 25-year history. Decisions there will determine the fate of OPEC and Saudi Arabia, OPEC's main decision maker. Three questions: What should the Saudis do now? What are they likely to do? What might happen? For example, will the Saudis go ahead with their oft-proclaimed threat to launch a price war, a move that could drop the oil price toward $10 a barrel from its current official average price of $28?

The overriding reality is the continuing drop in demand for OPEC oil – a result of conservation, fuel switching and non-OPEC production increases following the 1979-80 tripling in oil prices. OPEC must accommodate this declining demand by cutting production or dropping prices, or both. In fact, OPEC has cut its output from 32 million barrels a day (mbd) in 1979 to 16 mbd, Saudi Arabia from more than 10 mbd to 2.5 mbd. The price has fallen more than 50% (in constant dollars) from its 1980 peak of $36 a barrel.

It is clear that the Saudis, once a top producer and still holder of the largest reserves of both oil and money, have borne the brunt of the cutback – in a futile attempt to keep up the price. Their decision has benefited other OPEC members and non-OPEC producers, most of them holding small reserves and selling as quickly as they can in order to increase their revenues. Defending the high world price, however, reduces current profits for Saudi Arabia as well as their future market for oil. (Once insulation has been installed, a nuclear-power plant opened or a transcontinental gas pipeline built, there is no turning back to oil.)

Three Remaining Saudi Options

The Saudis have exhausted the option of cutting their own production – a mistaken decision to begin with. Their real oil income has fallen to nearly one-tenth; besides, they need the natural gas associated with their remaining oil production. They now have three options left: (1) the economically rational option of doubling production levels to five to six mbd; (2) the politically safer option (in the short run) of keeping their production below three mbd; (3) the desperate option of a price war, boosting their output to its maximum, perhaps over 10 mbd.

(1) Lowering the world price quickly to below $20 is economically sound but politically risky. According to my analysis, previously offered on these pages, there is an optimum price path for Saudi Arabia that maximizes their stream of (discounted) oil profits over time. The price calculated from this model is $20 in 1985, rises slowly in 1986-87, and then more rapidly to about $30 (in current dollars) in the year 2000. A $20 price probably would put an end to many alternative energy projects now in the planning stage or even partially completed. Synthetic fuel projects would certainly be dropped. Oil-exploration investments would be delayed or stretched out; the Soviet Union would face particularly hard choices. Non-OPEC oil production could cease its steady growth. In addition, all non-Arabian producers, OPEC and non-OPEC, including the U.S.S.R., North Sea, Mexico and Alaska, would experience large drops in current income. The U.S. as a whole, being a net energy importer, would benefit. Energy prices generally would decline, but especially those of oil and gas.

A Saudi decision, probably joined by Kuwait and the United Arab Emirates, to flood the market with lower-priced oil would hurt energy producers geographically close to Arabia, including Iran, Iraq, Libya and Egypt; so there are political risks attached to such a decision. In addition there is a psychological cost: The OPEC oil price has become a symbol of the strength of the organization. It would be difficult to explain to Saudi citizens that the lower price ultimately benefits Saudi Arabia.

(2) In order to avoid such political risks, conservative Saudi decision makers are more likely to keep their production low and make only a small downward adjustment in the price, to perhaps $24. This move would be shortsighted and repeat the mistake made in March 1983 when OPEC lowered the official price to $29 instead of biting the bullet by cutting the price close to $20. The effective world price (on the spot market and with quality differentials) is now about $26. At $24 not much would change, except that all producers, OPEC and non-OPEC, would make less money per barrel. (In the U.S., though, much of the loss would be absorbed by the Treasury collecting a reduced windfall-profits tax (WPT).

A $24 price would simply keep the oil glut going, as demand continues to decline, and especially as new production appears, for example, from Iraq.

A $24 price would simply keep the oil glut going, as demand continues to decline, and especially as new production appears, for example, from Iraq. (Iraq by 1986 is likely to put an additional one mbd on the world market through newly built or expanded pipelines.) And, of course, the end of the Gulf war would see increases in exports from Iraq and Iran.

A more detailed analysis also suggests that there would be no change in supply or demand in the short run. The only decrease in supply – probably negligible – could come from wells whose marginal production cost is $24 to $26 a barrel. The (short-run) marginal cost is made up of two components: a pumping cost (and other real resource costs), and a non-resource cost (WPT, severance taxes, royalties). But the latter cost can always be reduced, by negotiation or otherwise, in order to keep the well pumping.

Will there be an increase in demand – in the short run – if the price falls to $24? Consumption in the transportation sector may increase slightly if gasoline prices fall; for other sectors, gas and coal prices will adjust downward and provide competition. The big item in demand may be inventories; will oil stocks be built up at $24? I don't think so. I believe companies will be inclined to wait for the "other shoe to drop"; market psychology will expect the price to fall further, in view of pending supply increases from Iraq, and later Iran, plus the expectation of a continuing oil glut.

Lowering the price slightly has an advantage as well as a cost. It buys time – perhaps a year or so. The political risks during this period are bearable. Miracles could happen: OPEC may shape up as a cartel and really stick to agreed-to production quotas. Or, The value of the dollar may drop and thereby erode the oil price to the $20 level. (The Saudis may have hoped for such miracles in March 1983, but they have not been lucky – inflation has been low.) The cost, as mentioned earlier, is lower revenues for all OPEC members without any essential market changes, and the impression of OPEC weakness because of a continuing glut and downward pressure on price. These factors are self-reinforcing; lower revenues make OPEC discipline more difficult, which in turn encourages overproduction and price cutting.

(3) The price-war option is the most dramatic, carrying the highest political risk, but could be used successfully by Saudi Arabia to discipline the cartel and get OPEC members to stick with lower production quotas. In this scenario, which carries perhaps a 20% probability, the Saudis produce all-out, dumping oil until the world price plunged to a new plateau, perhaps as low as $10, or even less, for a short time. Once the point has been made, they would lower production to about six mbd and achieve a $20 price.

Saudi Costs Are Unmatchable

It would be a painful episode for Saudi Arabia, but much more painful for other producers who would be forced to stop producing from high-cost wells. Outside of the Middle East no one could really match Saudi production costs, estimated on the order of $1 a barrel, nor Saudi financial reserves. (Demand for oil would, of course, increase as companies and speculators jumped into the market to put the cheap oil into stockpiles.) The theory is that the price war would force OPEC members to sue for peace and promise to become good cartel members that help Saudi Arabia share the required production cutbacks more equitably. The whole event might not last more than a few weeks, and once demonstrated may never have to be repeated.

Non-OPEC producers also would be hurt by a price war. Net importers like the U.S. could protect themselves by a temporary import fee – of variable size to reach a certain target price. It would insulate U.S. producers and consumers from this temporary price glitch and transfer forgone OPEC profits to the U.S. Treasury.

All in all, the options for Saudi Arabia in Vienna are either unattractive or dangerous. It will need every bit of negotiating clout it has, plus luck.

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THE WALL STREET JOURNAL TUESDAY, FEBRUARY 18, 1986

Letters to the Editor

This Tax We Can Live With

Some comments on your editorial "Rich Man's Tax" (Jan. 28) lambasting a proposed higher gasoline tax:

First, let's call it what it should be: A user fee, to pay for the nearly $50 billion of annual highway costs that are now supported by general state taxes and state bonds. (The other $20 billion of costs are paid for by the nine cents federal and the—average—14 cents state gasoline tax.) Your editorial writers who drive to Manhattan pay tolls for highways, tunnels and bridges; that's not unfair, is it?

Next, let's assume that with $50 billion of gas tax revenues, the states and local jurisdictions can reduce other taxes, including the truly regressive sales tax, and stop selling highway bonds. Or, that the feds collect the increased gas tax at the pump and pass it through to the states; at the same time the feds cut the budget deficit by eliminating a whole range of subsidy programs now targeted to the states: public housing, mass transit, sewage treatment plants, among others.

With an appropriate motor fuel user fee (MFUF) installed, there would be no need—if there ever was one—for an oil import fee or a general energy consumption tax. Hold the applause, please; there's more good news.

A 50 cents per gallon MFUF will reduce vehicle-miles-traveled by about 10%. Yes, it will reduce accidents, as well as congestion. That's worth at least $60 billion per year to the nation. I'm not counting the reduced pollution, noise, stress, etc. Just the economic losses of lives lost, working days lost, and time spent in traffic jams.

Further, without affecting domestic oil production, the MFUF will cut oil imports—by about 30% as I figure it—decrease dollar outflow by over $10 billion, reduce the need for OPEC oil by about 10%, and thus put downward pressure on the world oil price. Not bad, what?

Also, with oil conservation improved by the MFUF, Congress can dismantle a whole gaggle of coercive and generally ineffective laws: Federal speed limits, gas guzzler taxes, mandatory fuel-efficiency standards. Do I hear loud cheers?

And wherever did you get the idea that a gasoline tax is regressive? You must have been thinking of that value-added tax. In a report published in 1979 I concluded that a gasoline surtax "is slightly progressive except at the extremes of the income distribution. This is a surprising result . . ." based on the work of A. Myrick Freeman and Nancy S. Dorfman who used Brookings data. Old data perhaps, but solid.

S. FRED SINGER
Visiting Eminent Scholar
George Mason University

Fairfax, Va.

Senator **Wallop**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Mr. Schuler, I follow your analysis down to the point where suddenly we are back at $30 a barrel for oil. I understand the Saudi's choice. They either continue to produce or they cut production. And it is that decision that you believe will be influenced by an oil import fee.

Is that correct? And then take me from that point in your analysis to the point that we are now in a world with $30 a barrel oil. There are a couple of steps there that I missed.

Dr. **Schuler**. There is a demand for OPEC oil that is in the order of 16 million barrels a day, 15½, 16 million barrels a day. I think no one would doubt that there is that order of demand.

There has been agreement in OPEC since 1984 setting quotas that total 16 million barrels a day. Now, clearly, they have not been honoring those quotas. And the hawks in OPEC say the reason we have not honored our quotas is because the revenue pressures are simply too great on us. When the Saudis manipulated the price of oil down, which they did in response to urging from the United States as well as their own long-term interest, they moved the price of oil down in March 1983 by $5 a barrel. And when that happened, that exacerbated the revenue pressures that were already on the members of OPEC, and the Saudis have foreclosed any possibility of raising price. So the only thing available to the other OPEC members to increase their revenues is to try to cheat on volume.

This is the reason why they are producing 18 million barrels a day instead of 16 million barrels a day.

Now as I perceive the situation, the Saudis are not benefiting either financially and they are hurting badly politically from this situation.

If you do the sums, last fall they were producing 2½ million barrels a day at $26 a barrel and they said that was inadequate revenues so they had to get their production up to 4.3 million barrels a day which is their OPEC quota. They are now producing 4.3 million barrels a day at $15 a barrel, and I think you will find that generates $500,000 less a day in current revenues versus what was previously deemed unacceptable.

So they have not solved their revenue problems. They still need to get the discipline of the rest of OPEC, and the rest of OPEC says the only way we will discipline ourselves is if prices go up so we can make it in price and give up our volume.

The Saudis have resisted that. But my contention is because the Saudis say we want prices arranged that will keep long-term demand for oil, now the United States comes along, puts on a crude oil import fee, and there is no basis for the Saudi rationale. The price to the consumer is up so there will be no greater demand. That is what all the so-called energy rationale, the conservation rationale, and so forth for putting on a crude oil import fee.

If the Saudis go along with an oil import—I mean don't react to an oil import fee, then there has simply been a shifting of revenues that previously went to OPEC, now to the United States, at least on the volume of U.S. imports.

So this adds to the pressure, and, as I say, becomes the straw that breaks the camel's back. At that point, I think it is entirely feasible that they go to the rest of OPEC, and they say, look, we don't want higher prices and you do; but we have got to have 4 million barrels a day or something in that order of magnitude. If you will all honor your quotas, we will permit prices to rise instead of continuing to release oil to drive it down.

Senator **Bradley**. And then it is a cartel decision to raise the price of oil from $15 to $20? Is that what you are asserting?

Dr. **Schuler**. Well, all I am saying is that the other side—the Iranians have said the price should be restored to $30. That is why I picked that number.

Senator **Bradley**. All right. Let us say to $30. If that were the case, why wouldn't that be, you know, one answer is we are then locked back into $30 a barrel oil. The other answer is it saves Mexico. Mexico would underprice them by a dollar or two, get $10 more than they are now getting, and they would not have any problem with the banks.

Dr. **Schuler**. That is correct.

Senator **Bradley**. I mean you see this as a monolithic cartel that suddenly sets the price at any place it wants.

Dr. **Schuler**. I am saying that individual producers have an interest in raising prices in order to get the revenues.

Senator **Bradley**. And you are saying there is no surge capacity in the United States, Canada, Venezuela, and Mexico?

Dr. **Schuler**. Venezuela is a member. Mexico are cooperators. I am not just talking Middle East. I am talking OPEC.

Senator **Bradley**. Mr. Chairman, could I just ask one quick question of Dr. Singer?

I am intrigued by your idea of saying that an oil import fee—we will just not call it a tax.

Dr. **Singer**. That is right.

Senator **Bradley**. What do we do with the revenue?

Dr. **Singer**. The revenues will be marginal. I hope the revenue will not even come in because I don't think once this is in effect there will be too many price swings below this correct level. When they do come in, they go into the Treasury and the general fund, and they stay there.

Senator **Bradley**. You don't expect there to be any revenue?

Dr. **Singer**. There would be occasional revenues.

Senator **Bradley**. Well, you know, the analysis of the bills is that if we had a $5 import fee that would mean $8 billion in revenue.

Dr. **Singer**. I am not talking about that import fee. I am against the straight import fee. I support the variable import fee that goes into effect only when the world price drops below the reference level, which will happen from time to time and may not last for more than a few weeks at a time.

Normally, this money would go to speculators and traders. It would never go to the consumers. They would never see the benefits anyway. In this case, under this proposal, it would go into the Treasury.

Senator **Bradley**. You have likened this to a countervailing duty case.

Dr. **Singer**. That is correct. Yes.

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Senator BRADLEY. Who do you think should petition the ITC that there is dumping going on in order to confirm that it is indeed a——

Dr. SINGER. Well, I would be glad to do it if I had standing.

Senator BRADLEY. But my point is the analogy holds up to the point where you actually have to determine that there has been dumping. That is done under the trade law by the International Trade Commission under a petition by the affected industry.

Dr. SINGER. Correct; yes.

Senator BRADLEY. Now my question to you is if we are going to view it this way, we need some substantiation that, yes, this is dumping.

Dr. SINGER. Yes; this can be done. I think we can provide an economically sound rationale to demonstrate that Saudi Arabia is dumping at this time.

Senator BRADLEY. Would you advise us not to go ahead with this concept until the ITC has determined that there is dumping?

Dr. SINGER. No. I think the concept should be enacted into law. I would simplify it, however, as I have indicated, and it should be available on a standby basis in case the ITC does not act according to the petition.

Senator BRADLEY. So you are saying that we should make an exception for the oil industry from the existing countervailing duty laws.

Dr. SINGER. No; not an exception. Natural resources are different from manufactured goods. For manufactured goods, you can tell pretty much what the manufacturing costs are. And also manufactured goods can be sold at different prices in different countries. For example, a Far Eastern manufacturer can sell semiconductor chips for one price in the home country and for another price in the United States. That would clearly be dumping.

But oil is a different commodity. Oil is fungible, in the sense that it has the same price all over the world. So you have to apply a different economic rationale.

But the purpose of dumping is the same. The purpose is always to squeeze out competition. It is a kind of "hysteresis" effect, if you know what I mean. Once you have squeezed out the U.S. oil industry, a good part of it will never come back. At $12, for example, Alaskan oil will stop flowing. Now, obviously, when the price rebounds, you will again get Alaskan oil back, but in the meantime, you will actually have lost hydrocarbons that you will never get back again.

Senator BRADLEY. Thanks, Mr. Singer.

Just a quick one to Mr. Hall.

It is good to see you again.

Dr. HALL. Thank you, Senator.

Senator BRADLEY. You say that the drop in the price of oil to date will produce a 2-percent increase in GNP?

Dr. HALL. Roughly speaking. There is some uncertainty in my mind.

Senator BRADLEY. That is the biggest number that I have seen. I have seen 1 percent, but now we are doubling it.

Could you give me the rationale for that? I mean that is an overwhelming fact because if that is true, if that is true, then Gramm-

Rudman is going to be a piece of cake because for every 1 percent increase in the growth rate, the Government will get another $78 billion over 5 years. So we get $30 billion a year; we have solved half of Gramm-Rudman right there.

Dr. HALL. Provided you don't enact the oil import fee.

Senator BRADLEY. That is right.

Dr. HALL. Let me clarify one thing.

Senator BRADLEY. You are asserting that we will raise $30 billion more from growth.

Dr. HALL. No.

Senator BRADLEY. I mean that is the revenue number from a 2-percent increase.

Dr. HALL. This is a one-time effect from a one-time price change. My analysis—and I think this is pretty much agreed to by the people who have looked at the problem besides myself—is that the peak of the real effect, the effect on real GNP, occurs about a year after the price change. So, for example, when prices went up in 1974, the worst period of the recession appeared in 1975. Similarly, if prices had dropped at the beginning of 1986, then we would expect around yearend or the beginning of 1987 that we would have 2 percent more real GNP at that point. But it won't keep on growing after that. It would be nice if it would, but it will not.

Rather, we get a—I estimate that the total longrun effect is maybe double that, maybe 4 percent all told. So it would be important for a couple of years, but then it would fade out.

But, again, the numbers even over that period—the budget will look a lot better with the brightening of the outlook that has occurred. And that has happened anyway. And part of it you've already seen. The outlook has improved. The revenue outlook is better. The overall outlook for the economy is better, and I would attribute that almost entirely to lower oil prices.

Senator BRADLEY. That is very strong testimony, I will tell you that. It convinces me this is 1926 and not 1929.

Senator WALLOP. Senator Boren.

Senator BOREN. I would just like to ask Mr. Hall: A little earlier we have had some discussion of the impact of the sudden drop in commodity prices on the financial system, on the banking system in particular. We have had—and I certainly see it from the standpoint of my own State, but it is something that is afflicting the whole country. We have had a deflation of land, severe deflation of land through the whole midsection of the country. The USDA tells us there is now about $160 billion worth of total domestic debt that is in the hands of those—agricultural debts that are in the hands of those that will be unlikely to be able to service it on time. So we have 4,500 banks that have a fourth or more of their portfolio in that kind of land. Twenty-five hundred have over half of their portfolio in that kind of land.

Now on top of that, we have a sudden deflation of another basic unit of value that is collateralizing debt in this country. With the value of oil and gas reserves in the ground, about another $160 billion. And that value of that collateral has dropped in half in a 12-month period, approximately.

Also, that sudden drop has an impact on the ability of some of the Third World nations to pay their debts to us on time. That is about another $160 billion in terms of their total debt to the American financial system.

What, if any, steps do you think that we should take to try to focus upon assuring the soundness of our financial system when we have that kind of very severe deflationary impact on the value of those collateralizing assets?

Dr. HALL. Senator Boren, my testimony, the written testimony, touched on the issues that you mentioned to begin with.

In the first place, for the issue we are considering here, there is no question where the interest of agriculture lies. Agriculture has always favored free trade. It would be very harmful to agriculture to stand in the way of lower oil prices.

One of the hopes for agriculture that would end the land deflation that you spoke of, which has been very cruel and harmful, would be the restoration of the sensible value of the dollar, which is one of the results of lower oil prices. Again, if we reverse that, the same deflationary forces in agriculture would be unleashed again, and the agricultural debt problems would worsen instead of brightening. Banks dependent on agricultural loans would have further problems.

But as it stands, lower oil prices has relieved a lot of those problems, and I think that relief will continue. That is one of the reasons why it is important to give the American economy the benefit of lower oil prices.

Senator BOREN. Well, what do you do about the—I wish I could share your optimism of that situation in agriculture. If you look at the USDA projections, even with the fall in oil prices, you will see that incomes are projected by them to go down about another 7 percent this year from last year. And since there were $14 per farm in my State last year, I see 7 percent lower than $14. I guess we will be down to about $10 per farm this year. So I don't quite share your optimism.

But my point is: The banking regulators do not allow you a prolonged writedown of the value of assets. Now we have been discussing that with agricultural land. The fact that the regulators come in and say you have got to write that down all at once; it is making institutions insolvent.

Now you have another $160 billion of debt. We are not talking here about the long-term benefits of whether it is in the long term beneficial where oil prices ought to be or not. I am talking about how do you handle the immediate regulatory problem of the financial system when they are potentially confronted with—let's say an examiner walking into a bank next week and saying write down all of the—say write down $10 billion on your books to $5 billion because that asset is deflated.

How do you deal with that problem? What would you propose for dealing with that immediate problem in terms of something that could snap the whole economy before we even have any of these long-range benefits that you hope to see.

Dr. HALL. Senator, we have a lot of experience in dealing with the problem you have described. We had the Continental Illinois problems in 1982, and smaller problems before and after that. And I think we have had a lot of successful experience.

In the first place, all economists would identify the most important target as being to preserve the value of deposit. And we have a system of deposit insurance. And, if necessary, I think the Treasury has to stand behind deposit insurance. That has not been necessary so far, but it could become necessary. And I think that would be the right solution.

The most important thing is to avoid the kind of spreading financial collapse that occurred in 1929 and afterward.

That has not happened. Even under the immense strains of 1982, we did not have that problem. We have learned how to solve it. And the answer is very simply to stand behind deposits.

Beyond that, I don't think there is a strong case for bailing out the shareholders or even the bondholders of banks.

You know, capitalism has ups and downs. And the people who own those stocks and bonds are not poor. They deliberately took risks. And sometimes it pays off very well. And certainly those who have been in the stock market outside of energy recently has done extremely well. Those stocks and bonds are held in diversified portfolios. It is not necessary to be so sensitive to what happens to them for that reason. It is important to protect the depositors. It is important to prevent a spreading financial collapse, but it is not essential to bail out the shareholders of large banks.

Senator **Boren**. Well, I happen to be one that agrees with you about that. And that is the reason I opposed the way in which the Continental Illinois was bailed out so that the stockholders were partly bailed out. I did not think that was quite fair when we had uninsured depositors in our State that were not helped.

But I think that I would just say that I don't think the answer is, well, let us pump another $100 billion into the FDIC, because they only have about $22 billion, and the Continental Illinois by itself used 1.5. And, believe me, if a small shopping center bank in our State can trigger that kind of problem in the Continental Illinois Bank, I think you are being a little bit Pollyannaish in suggesting that the potential of three $160 billion radical shifts in the value of assets or potential defaults could not have some disrupting effect on the financial system.

Dr. **Hall**. Well, Senator Boren, the stock market has risen hundreds of billions of dollars over the last few months. You have got to factor that in as well. I mean you have to take the good news as well as the bad news and take the sum of it.

The general news in the financial markets has been outstandingly good over the last few months.

Senator **Boren**. I am glad you think so.

Senator **Wallop**. Let me begin by thanking all three of you. This has been a series of fascinating snapshots of the proposals and the situation that exists.

I would say to you, Dr. Schuler, that I could not agree with you more that there are those around who are viewing it as a revenue-raising measure. That is why I took pains in my opening remarks to tell you that that is a lousy concept.

And I see it proposed in the House, and I see it proposed in the Senate for those very purposes. If it has any value at all, it has value only as energy policy. And that is why I appreciate some of Dr. Singer's concepts that we are hearing.

But let me say, just for the panel—I was reading in the Wall Street Journal last November, and there was a little teeny sort of thing, a total of maybe four column inches, on the editorial page of the Wall Street Journal on November 11. It was a little statement by a man named Muhammed Acasem, who is the economist at the Saudi Fund for Development in Riyadh. And written there was a wonderful warning that was put in plain print; I mean we were not lied to.

He just said this in the article, outlining the strategy for the recovery of OPEC: "As early as the end of the decade the poor oil producing countries will have depleted their resources to the point that the six Persian Gulf petroleum producing countries will possess a significant portion of the world oil reserves." He states that "These gulf producing states will then be in a position to better control the market through strategic flooding, if necessary"—to use his words. "In addition, the new unity which will result among the remaining OPEC powers because of common religion and natural resource-based economies will make it easier for them to agree on policy and share information that will allow relatively slow depletion rates and a stable growth for oil prices over time."

Now that, to me, is a statement that they want us out of the business. Do you agree with that?

Dr. **SCHULER**. They certainly want to capture control of it for themselves, and, indeed, they will do precisely that.

Senator **WALLOP**. Under any set of circumstances?

Dr. **SCHULER**. The evidence—as long as we are as dependent upon petroleum as we are today, I think that that is going to be the case because at that point you have to look at where the crude reserves are and what the cost of production of those reserves are, and that, as you point out, is there in those few countries in the Middle East.

Senator **WALLOP**. Is not that then an argument on behalf of Dr. Singer's thoughts to these events that by artificially reducing the price, you increase the level of dependence upon those very resources?

Dr. **SCHULER**. But I don't think that they are the benefits that are hoped for in terms of putting on a crude oil import fee. I think they are outweighed by the burdens that are created by that.

Senator **WALLOP**. Would you have us do anything?

Dr. **SCHULER**. Continue to make offshore leasing available, continue to——

Senator **WALLOP**. All right. Now we are getting down to what is at issue. How is anybody going to bid on offshore leases if the price is $10 or $12?

Dr. **SCHULER**. Senator, I guess the answer——

Senator **WALLOP**. I mean I agree with you that we ought to do it, but I just wonder how anybody would respond to that.

Dr. **SCHULER**. Let me respond in this way just quickly. I think it is a nonproblem, to tell you the truth. I don't think we are going to see oil prices in the range of $15 a barrel for very long. And as I said in my testimony, at such time as I become convinced that OPEC is totally destroyed, then I am perfectly prepared to change my view and analyze the security advantages of an import fee.

But that, I don't think, is the case at this time.

Senator Wallop. But in that respect, then, in that narrow respect, you are not all that far from Dr. Singer who does not think it is going to last very long either, particularly if we establish some price.

Dr. Schuler. But if you establish that price, you get the burdens that go with it. And that is where I think—you know, the independent producers are the people who presumably would benefit the most from this. And they obviously will testify for themselves, but the position they took last fall was that the benefits were outweighed by the burdens.

Senator Wallop. I must say that there is nothing in the world as futile as predicting energy prices. I have been here long enough to see a lot of interesting predictions. Dr. Schlesinger said there was no more natural gas to be found. We had but to democratize the misery. Oil is going to be up $65 a barrel.

Now I am reading the latest administration forecast prepared in December 1985 for the year 1986 and it shows an oil price of $24.76. That was December of this year. I mean it is sort of a futile thing which brings me back to the argument that we have yet to examine in any comfortable way for me—and there is a national security argument. Can you turn on and off a production and exploration industry like that? And can you—Dr. Hall as well—shield the economy from the very kind of violent wrenches that took place in 1973 and 1979?

Dr. Singer. I think the real dangers that we face are rapid and extreme price fluctuations. Saudi Arabia certainly has the capability of doing this because they can vary their oil production in the short run up to about 7 or 7½ million barrels a day, in the long run up to perhaps 10 million barrels a day. And we know they have gone down to 2½. So this is a factor of three or four in their production. And they can do this in a very short time.

They seem to have the willingness also to vary their production as they have shown in the recent past.

This means that they can thoroughly jiggle the price up and down by strategic flooding of the oil market, and thoroughly discombobulate our domestic conservation effort.

Senator Wallop. Muhammed Acasem literally stated that that is what they were setting out to do.

Dr. Singer. We have to be able to defend ourselves against price fluctuations. We should use a variable import fee, because that will stabilize the price on down dips. Against upswings, we should use the strategic petroleum reserve if they push the price up too high for a short time. We should release oil from SPRO to fight that.

So we do have measures of defending ourselves. And my prediction is that the other industrialized countries will join us in all of this. They will find it in their own best interest to do the same thing we are doing.

Therefore, I think all these discussions about international competitiveness are irrelevant. They are red herrings because they will all do the same thing that we are doing. And we will all be on the same basis.

Senator Wallop. Dr. Hall.

Dr. HALL. Senator, I am a little puzzled. The whole discussion has taken place only in terms of the interest of American producers, and I have not heard a word about American consumers.

Senator WALLOP. I beg your pardon. My introductory statement was directly aimed at American consumers.

Dr. HALL. Excuse me. I meant in the last couple of minutes.

Senator WALLOP. Oh.

Dr. HALL. Just in talking about this issue in terms of——

Senator WALLOP. But I mean isn't the American consumer as badly damaged by the kinds of economic dislocations that we had in 1973 and 1979 as he is by anything we are talking about today?

Dr. HALL. It is very simple. High prices are bad for consumers and low prices are good. When my department store runs a special on shirts and sells shirts for half price, I buy a bunch, and I benefit from that.

Senator WALLOP. Yes; but you cannot buy a bunch of gas and put it in your backyard.

Dr. HALL. Well, you can certainly buy oil.

When world oil prices are low, it is a time when consumers should be allowed the full benefit of it. Another point I would make to follow up on what Dr. Singer said is, just as he said, release the strategic petroleum reserve when prices are high; we should fill it when the bargain is available.

And I concur with the proposition that probably oil prices are going to rise from the point where they are today over the next decade.

Let me make one further comment with respect to the production side. The concepts of strategic flooding that you mentioned and the threat that that poses to American production, I think, is negligible.

What American producer is so stupid as to shut down a well just because of a temporary reduction in oil prices, when the market is going to come back to life? You don't have to cap a well. All you have to do is lower its production or even store its output.

Senator WALLOP. I don't think geology works that way.

Dr. HALL. You can certainly store it.

Senator WALLOP. You know, cash-flow and banks and other things work that way, but geology does not work that way.

Dr. HALL. OK. The worst thing you do is you sell it for—let me remind you also that the posted price in Texas today is not $12 a barrel. It is close to $20 a barrel. So, you know, the situation in the oil market is just not as devastating as it has been made out to be. And I think the mentality that we are attributing to American oil producers is very narrowminded and stupid, and I don't think it is right.

The true victims of Saudi Arabia today—I agree that strategic flooding is taking place, but I think the strategy is quite different. They are trying to get the major European producers, Britain and Norway, to agree to output limitations and essentially become part of OPEC. That is where the leverage lies. They don't have any leverage over the stripper operator in Texas. They have tremendous leverage over Britain.

Senator WALLOP. With all respect, they do have a lot of leverage over the stripper operator in Texas. You know, the volume of those

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wells is so small that at a given point, nobody is going to continue to produce if in the act of producing he owes his bank a dollar for every barrel he lifts. And when it is set on those things, you lose it.

Dr. HALL. The marginal operating cost of that type of production is much lower than the cost that is necessary to bring them into production.

Senator WALLOP. Depending on——

Dr. HALL. It is a costly form of production.

Senator WALLOP. Depending. Depending.

Dr. HALL. Depending. But I would be very surprised from what I saw of the behavior of that in previous fluctuations. It is pretty sluggish. And I think this notion that we are going to lose a lot of American production capacity permanently because of a temporary reduction in world oil prices is just vastly an overstatement about that.

And, again, the potential victims—the Saudi strategy, which may well be a sensible strategy for them, is to try to get reductions in North Sea oil. They have been very clear on that point. They have not targeted American producers as the victims. They have targeted European producers. And that is what they are trying to do. They are trying to get a balance reduction in output of the major producers, and it is a political issue, and they are using a political weapon; namely, low prices.

And I think it is really important to realize that that is the intent of the Saudi strategy; not to shut in production in the United States.

Senator WALLOP. Do you agree with that, Dr. Schuler.

Dr. SCHULER. I don't agree. That is certainly what they say, but it seems to me that what it is really aimed at is the cheating that is going on within OPEC. That is who the Saudis are after. That is where the significant 2 million barrels a day volume is. But it is a lot easier to say I am declaring a price war against some people in the North Sea than it is to say I am declaring against Iran and Iraq and Libya and so forth.

So I think it is really aimed at OPEC.

Dr. HALL. I don't disagree with that at all. Let me just restate though. The main point was that I think the notion that we have to avoid letting U.S. consumers have bargains when world prices are low because it will have this devastating effect on shutting in domestic production permanently, I think, is a great overstatement.

I think we are standing by on the sides. If it is Iran and Iraq and Britain, Norway that are the intended victims, we can just stand by and let our consumers take advantage of the temporary bargain.

Senator WALLOP. But would there be any moment in time at all when you would hesitate about stating that policy?

Dr. HALL. You know, it is such an open-ended question, I am not sure how to answer it.

Senator WALLOP. What I mean is, Is there no time when the national security, national economic security, would become an important consideration?

Dr. HALL. When you say the national economic security——

Senator **Wallop**. Well, you have got two sets of national security. You have got national strategic security; you have got a national economic security, and they interrelate.

But is there no moment in time when the threat to either the economy or the strategic ability of this country to react in crisis would change your opinion on that?

Dr. **Hall**. Well, again, let us be clear about the direction of this. Lower oil prices are unambiguously good for the economy in general. That is an uncontradicted conclusion of every macroeconomist who has looked at it.

Senator **Wallop**. Yes. Presuming that you do not create such a dependence upon them that leaves you with the same vulnerability that we had in 1979. I mean, good God, nobody can say that was good for the economy.

Dr. **Hall**. The other side of the coin, of course, is that when oil prices rise, it inflicts damage on the economy.

The conclusion clearly is that the ideal thing for the United States would be to have cheap oil which is permanently cheap. Now there is no way to achieve that.

We are shooting ourselves in our feet if the moment that we have a chance to get some relief in the form of low prices we do not take advantage of it; we try to prevent ourselves from taking advantage of it by putting in an oil import fee.

And, again, as Dr. Singer stressed, we need to have standby plans to deal with sharp runups in price, especially if they can be seen to be temporary as is the case if they are motivated by war. And that is why we have a strategic petroleum reserve. And I think it is important to have an even bigger SPRO. And there is no better time to create one than during a period of a temporary reduction in world oil prices.

Senator **Wallop**. Well, that is one of the other nice pieces of the energy policy that we have seen come out of the administration that we have lowered the——

Senator **Bradley**. We have stopped it.

Senator **Wallop**. Yes. Clearly, I think both Senator Bradley, and I could go on for a long time with this panel, but we——

Senator **Bradley**. Could I just ask one quick question to Mr. Singer?

Do you agree with the original congressional intent on the SPR that the optimum level from the standpoint of using it to spike runups in price or for national security should be about 750 million barrels in storage? That was the original——

Dr. **Singer**. No; I did not agree with that. I have never accepted the analysis.

Senator **Bradley**. What is your optimum?

Dr. **Singer**. I do not have a calculated optimum.

However, now that we do have a 500-million-barrel SPRO, I am disappointed by the fact that, No. 1, we have not completely tested it; No. 2, that we are not using it actively. I would like to see it privatized. And because eventually it will have to be sold to domestic refiners—there is no reason why we cannot do this before an emergency.

What worries me, of course, is that bureaucrats will be sitting on the SPRO forever waiting for the proverbial rainy day which will never come.

Senator BRADLEY. Yes. What we need is a much more auction-oriented use of this device.

Dr. SINGER. I agree that we need a more market-oriented use of this device. Now in the best of all possible worlds, I would say that when the price goes down—let us say if it dips down to $10, we should all be out there buying oil. But I don't see those buyers now. Where are they? Where are these bargain hunters? Why isn't the market working as it should be bringing the price back up to $22? Because it is not working we need this variable import fee. If the market were working properly, people should be out there now buying this oil and driving the price back up again.

Senator BRADLEY. Mr. Hall, you said you thought it should be a larger SPR?

Dr. HALL. Yeah. Again, I——

Senator BRADLEY. You don't really know, really, do you?

Dr. HALL. Well, let me say first of all that Dr. Singer has correctly identified the central issue. Will we ever use our strategic petroleum reserves? I watched in anguish in 1974 when we had the Naval Petroleum Reserve and other opportunities and nothing was done whatsoever to stimulate the domestic supply. And, in fact, we took only perverse actions such as putting in price controls.

I doubt our willingness to use these tools. And that is my main misgiving about it. As a matter of theory, though, I think it clearly would be a good idea to have a very large petroleum reserve and no better time now than to fill it.

Senator BRADLEY. Thank you.

Senator WALLOP. Let me just say that I don't really quarrel with the idea of trying to maintain the benefits of falling prices, but I cannot leave that in a vacuum. I just don't think it is responsive. Maybe I can come down to a conclusion that is similar to yours, Dr. Hall, but I don't think that you dare look at it without looking at other things at the same time. And I am really concerned that geological forces are sometimes not market forces. And I am just concerned. And I feel that we have benefited by your testimonies and I think we will continue to over the rest of today and tomorrow. But we will never get to the rest of today unless I excuse you all.

I appreciate very much your taking the time to come here to give us the benefit of your witness on this.

The next panel consists of Leonard P. Steuart, president of Steuart Petroleum Co., Washington, DC, on behalf of the Independent Fuel Terminal Operators Association; Robert L. Bradley, research scholar, Citizens for a Sound Economy, Houston, TX; Lawrence Goldmuntz, Dr. Lawrence Goldmuntz, president of Economics and Science Planning, Inc.

Mr. Steuart.

STATEMENT OF LEONARD P. STEUART II, PRESIDENT, STEUART PETROLEUM CO., WASHINGTON, DC, ON BEHALF OF THE INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION, THE NEW ENGLAND FUEL INSTITUTE, THE EMPIRE STATE PETROLEUM ASSOCIATION, THE PENNSYLVANIA PETROLEUM ASSOCIATION, AND THE FUEL MERCHANTS ASSOCIATION OF NEW JERSEY

Mr. STEUART. Thank you, Mr. Chairman. I am pleased to be with you today. In recognition of the late hour, I am going to give you a very brief comment and submit my 50-page testimony for your consideration.

Senator WALLOP. Thank you. I would appreciate that.

Mr. STEUART. I would also like to submit testimony from the Independent Gasoline Marketers Council for the record.

[The information from Mr. Steuart follows:]

Subcommittee on Energy and Agricultural Taxation

Finance Committee

United States Senate

ON BEHALF OF

INDEPENDENT GASOLINE MARKETERS COUNCIL
1133 Fifteenth Street, N.W.
Washington, D.C. 20005

RE: S1997 AND S1507

Legisglative Proposals to Tax Imported Oil

Statement submitted by:

Jack A. Blum
1133 Fifteenth Street, NW
Washington, D.C. 20005

February 27, 1986

The Independent Gasoline Marketers Council is a trade association of non-branded wholesalers and retailers of motor gasoline. The Council is opposed to new energy taxes of any kind and is especially opposed to oil import fees.

Almost everything that can be said about the problems with an oil import fee has been said as the debate has heated up. It has been pointed out that a fee is inflationary, and that it would curtail economic growth, be a regressive tax, provide a windfall for domestic producers, create competitive imbalances in the petroleum industry and in industries which use petroleum products, create regional imbalances, injure the highly competitive transportation sector of the economy, injure energy intensive exporting industries as well as cause foreign relations problems, especially with Mexico, Canada and Venezuela. We subscribe to all of these points and will forgo the opportunity to reiterate them in detail.

Instead, we will focus on the arguments for an import fee and attempt to test their strength. Later we will examine some of the competitive implications for the oil industry, and through that analysis cast some light on the motivation behind the present push by some industry participants for a fee.

Some supporters of a fee argue that the sharp drop in oil prices has placed the domestic industry in a desperate situation which will threaten domestic production and increase foreign dependency. To add emphasis to their statements reference is frequently made to the drop in the drilling rig count and the plans of various companies to curtail spending for exploration and development.

There is no question that the domestic producers are having a hard time. The hard time has been going on for the last four years and it is the result of the restoration of free markets in the oil industry at the beginning of the Reagan administration.

But the problems of the domestic producers are generating a correct market response, that is to allow supply to come into balance with demand. At the moment there is an excess of production capacity over demand for crude, and there will be excess capacity for a number of years to come. In that environment it makes no sense to encourage the development of even more productive capacity for which there is no demand and which will have to be either protected or subsidized or both.

The best available evidence suggests that there is a finite amount of oil available in the United States. As with all mineral reserves the amount available depends on the amount you are willing to spend to get it. At some point no amount of money will produce more because the reserve is exhausted. As a country our choice is whether to use the domestic reserve now or use it later. To use it now we will have to keep our prices far higher than the prices which prevail in the rest of the world, placing

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our manufacturers and consumers at a serious international competitive disadvantage.

Another way of putting the question is will the U.S. tolerate a somewhat great foreign dependency today at low price levels in exchange for having some competitively priced reserves in the year 2025 or do we wish to pay 2025 prices today and face total dependency on foreign reserves later? We think the answer to the question is obvious.

A related argument for an import fee is that it is needed to protect the banks which made large oil loans. With all due respect, we believe those banks should have very little claim on the public purse for the loan decisions they made. The problems the banks now face are problems in loan underwriting, portfolio imbalance and internal management.

One of the questions every bank lending officer should have asked is, what happens to me if the price goes down? All too many of the banks may have answered, the government won't let it happen. The message back to the banking world as a result of this crisis should be, where government protection from the forces of the market place is involved don't bank on it.

American consumers, the independents who guessed the future of the oil market correctly, and the industries which planned appropriately should not be asked to pay for the bad business decisions of companies which bought out other companies at too high a price, or for the decisions of the bankers who made the loans which facilitated the buyouts.

It has been argued that an import fee will be painless and invisible. The drift of this thinking is that the decline in the price of oil makes it possible to slip a tax on imported oil without anyone noticing. Since we are used to paying higher prices and import fees are hidden in the price, consumers won't realize the impact.

By the time this Congress would get around to enacting an import fee, however, prices would have been sharply lower for months. An import fee of the order of magnitude under discussion will raise prices between fifteen and twenty five cents a gallon. Without question that will be noticed.

But more important than the political consideration is the fact that everyone will have had the chance to discover more productive ways to use the money that was paying for fuel. That discovery will be the trigger for a real economic boom which an import fee will abort.

Finally there is the argument that we need the money to (and here take your pick); (1) reduce the deficit, or (2) preserve some tax incentives which may be wiped out in tax reform.

The economic growth lower oil prices produces will more than pay for the revenue which might have been gained by an import fee. This is a point subscribed to by a surprisingly large number of economists within and outside of government. If they are correct, using an import fee to reduce the deficit is cutting off your nose to spite your face.

Using import fee revenues to finance tax breaks is be a flat statement by the Congress that it can, in its wisdom, better direct the benifits of lower taxes than the marketplace. Most of the tax benefits that the tax reform bill would eliminate are incentives to one sector of the economy or another. Tax revenue is forgone to encourage certain kinds of behavior. We believe that the overall incentive to greater economic activity provided by lower oil prices beats the collective wisdom of the tax writing committees by a mile.

A few words are in order about the petroleum industry and the winners and losers if an import fee proposal or other tax is placed on oil or on other forms of energy. Understanding who these winners and losers are is central to understanding the somewhat convoluted positions some of the proponents of energy taxation take. It is also central to understanding that energy taxation is a swamp which will lead to reregulation of the industry to preserve equity.

Our favorite debate among proponents of the fee is the argument the folks at Valero Refining have had with the rest of the independent refiners and the conditions the rest of the independent refiners have placed on their support for a fee.

Valero is one of the refiners which spent a lot of money upgrading their facility so that it can use residual fuel oil as a feedstock. If there is an import fee with an exemption for residual fuel oil, New England may feel better but Valero will positively glow. We have heard that when the other competing independent refiners saw the draft bills with exemptions for residual fuel oil they were not pleased and have passed that message to the sponsors.

The sponsors are thus left with the choice of helping Valero and New England, not creating an exception for New England, or putting a fee on residual fuel oil imported as a refinery feedstock but not on fuel oil imported as a fuel and figuring out how to enforce the provision.

The independent refiners as a group want a fee on crude but only if there is a differential fee on products. Without a differential to protect them, or perhaps a program such as the entitlements program to equalize crude costs, the crude-short independent refiners will be at the competitive mercy of their domestically integrated bretheren.

Then there are the refiners who have made bad business decisions and would like import fees established to bail them out. Texaco needs high crude prices to satisfy its bankers and justify its purchase of Getty. With 20/20 hindsight one wonders whether Texaco would have bid for Getty at the price it wound up paying.

There has been some joking in the industry that Texaco's defense in the Pennzoil case will be to claim that Pennzoil owes Texaco money for saving Pennzoil from a bad business decision.

Atlantic Richfield is another company looking for a way out of the consequences of a bad business decision. Arco decided that it wanted to stop being dependent on imported crude. To that end it sold all of its East Coast refining and marketing and concentrated on becoming the dominant producer/refiner/ marketer on the West Coast. After liquidating the East Coast assets at firesale prices, the cost of imported crude dropped, making the recently disposed of assets highly profitable and leaving Arco with domestic reserves which are declining in value.

Compounding Arco's problem was the decision to go deeply into debt to head off a hostile takeover attempt. The restructuring would have been brilliant if the price of crude had stayed the same or risen. Now that it has collapsed Arco is hard at work promoting an import fee.

We don't think the Finance Committee should save their bacon at the expense of the rest of the country.

Finally, we recognize the pain being felt by the producing states as the revenue from royalties and taxes stops flowing into state treasuries Clearly this revenue loss alone would motivate a representative from a producing state to ask for an oil import fee to restore state finances. But those pleas are on par with New York's delegation asking for federal help for its welfare problem and Florida's delegation asking for help in handling recent immigrants.

Perhaps federal transfer payments to Texas and Lousiana to support the state budgets are justified, but perhaps they aren't. The issue should be debated on the merits.

We hope that after a careful examination of the energy tax issue this committee will reject the pending proposals and return to the business of tax reform and deficit reduction using less controversial methods and that lack the manifest pitfalls of energy taxes.

Mr. STEUART. My name is Leonard Steuart, and I am president of the Steuart Petroleum Co., a local wholesaler or retailer of home heating oil based in Washington with facilities in Maryland, Virginia, Georgia, and Florida. I am testifying on behalf of an ad hoc coalition of petroleum marketers opposed to oil import fees or other barriers to imports. This coalition includes the Empire State Petroleum Association, the New England Fuel Institute, the Pennsylvania Petroleum Association, the Fuel Merchants Association of New Jersey, and the Independent Fuel Terminal Operators Association.

Together, the members of these groups market most of the home heating oil and residual fuel in the Northeast. We serve approximately 8 million homes and businesses.

We are opposed to import fees because of the severe damage that those fees would cause to the independent marketing industry and to our consumers. As independent marketers, we depend on the availability of imported petroleum products for our customers. For the most part, we buy domestic products. Without economically priced imports, however, we would be at the mercy of the majors who have curtailed or eliminated their historic role as suppliers to independent marketers.

Independent marketers will be devastated if Congress imposes import fees on petroleum products that exceed import fees on crude oil. Such a differential fee structure would place independent marketers at a severe disadvantage with domestic refiners. This is grossly unnecessary and will have serious adverse consequences.

Independent marketers have provided most of the competition in the fuel oil and home heating oil market. Their competition has benefited consumers significantly. When prices are declining, competition from independent marketers guarantees that the lower prices are passed through to consumers quickly. When prices are rising, competition from independent marketers keeps refiners' margins in check. Large fees on imported products are sure to eliminate competition from independent marketers. If this occurs, there will be little check against monopolistic and discriminatory pricing by refiners, particularly and during periods of tight supply in rural areas where there are very few suppliers.

There is no reason for a national energy policy that tilts the entire market toward domestic refiners. Imports of petroleum products represent a small fraction of domestic consumption. Import penetration of gasoline and fuel oil is only about 6 percent.

Domestic refiners supply more than 14 million barrels per day of a total daily consumption of about 156. Imports provide healthy competition but not a threat of extinction.

Moreover, lower crude oil prices offer major benefits to domestic refiners. You might recall, Mr. Chairman, that when the idea of an import fee was first proposed over a year ago, it was the independent refiners that needed unique and special protection. Those independent refiners are doing quite well today, and I am submitting for the record an article that appeared in the New York Times on Sunday entitled "Refiners Breathe a Sigh of Relief." This has been coming about as a result of the lower crude prices and the availability of net back deals.

[The information from Mr. Steuart follows:]

Career Services
Business Opportunities
Employment Advertising
Wholesale Offerings

The New York Times
Business

Shoot

Sunday, February 23, [illegible]

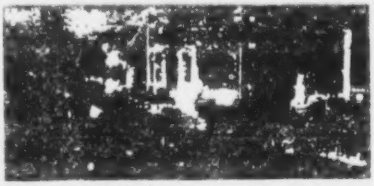
Section 3

Refiners Breathe A Sigh of Relief

Cheaper crude oil has revived the nation's independents

By [illegible]

[illegible]



The [illegible] refinery in Lake Charles, La.

Posted Prices for a Key U.S. Crude Oil

[illegible]

Mr. STEUART. The fall in crude prices may change the balance between refiners and marketers, between the majors and the independents, and between domestic and imported products; however, we are convinced these changes will benefit independent marketers and refiners. Before any precipitous action is taken on import fees, Congress should evaluate the industry's experience with lower prices.

Furthermore, we do not think that oil import fees can be imposed without regulations and bureaucracy. We have already heard many calls to exempt heating oil or to exempt specific exporting countries. You have only to recall the bureaucracy that existed in the 1970's during the period of controls at that time. I like to call it the Lawyer's Relief Act of 1973.

We should have learned our lessons from those times. Controlling the minimum price for oil will be as complex as controlling the maximum price for oil. It is a job much better left to the marketplace.

On the economic issues, which we have discussed in our statement, we will certainly defer to the testimony that has preceded me. I was particularly impressed with Dr. Greenspan, Dr. Hall, and Professor Schuler's testimony on the positive impacts of lower oil prices.

I thank you for the opportunity to appear before you today, sir.

Senator WALLOP. Thank you, Mr. Steuart.

[The prepared written statement of Mr. Steuart follows:]

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STATEMENT
of
LEONARD P. STEUART, II
PRESIDENT
STEUART PETROLEUM COMPANY

before the
UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

on
PROPOSALS TO TAX OIL IMPORTS

Appearing on Behalf of

EMPIRE STATE PETROLEUM ASSOCIATION
FUEL MERCHANTS ASSOCIATION OF NEW JERSEY
INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION
NEW ENGLAND FUEL INSTITUTE
PENNSYLVANIA PETROLEUM ASSOCIATION

Washington, D.C.
February 27, 1986

I. INTRODUCTION AND SUMMARY

My name is Leonard P. Steuart, II. I am President of Steuart Petroleum Company, a wholesaler and retailer of home heating oil, residual fuel, and gasoline in Maryland, Virginia and Washington, D.C. I am testifying on behalf of an ad hoc coalition of petroleum marketers opposed to oil import fees or other barriers to imports. This coalition includes the Empire State Petroleum Association, the New England Fuel Institute, the Pennsylvania Petroleum Association, the Fuel Merchants Association of New Jersey and the Independent Fuel Terminal Operators Association. Together, the members of these groups market most of the home heating oil and residual fuel in the Northeast. We serve approximately 8 million homes and businesses.

We are strongly opposed to import fees, either in the form of a flat fee of $5 or $10 per barrel, as proposed by Senator Boren in S. 1507, or as a floating fee that establishes a floor price for imported crude oil and an additional fee on products, as proposed by Senators Wallop and Bentsen in S. 1997.

As a matter of tax policy, import fees are regressive and inefficient, and therefore have no legitimate place in tax reform or deficit reduction. We have also considered the impact of each of these proposals on economic or energy policy, in light of the recent decline in world crude oil prices. We have concluded they would seriously harm the national economy, and would discriminate against oil consuming sectors and regions of the country, particularly the Northeast.[1] In addition, import fees would hamper the U.S. competitive position in world trade.

Crude oil import fees also create incentives to "drain America first", which will deplete the resources needed for a future emergency. Import fees on petroleum products would be even more costly, impairing the competitive viability of independent marketers without any benefit to producers. Such long term impacts far outweigh any short term benefits that protectionist legislation would confer on domestic producers or refiners.

As petroleum prices fall to free market levels from the excessive prices maintained by OPEC, the independent producing sector and related industries may merit some special consideration to avoid undue hardships and maintain production incentives. However, such special treatment must not be import protection which deprives all Americans of the benefits of economic growth, higher employment, and lower inflation that falling oil prices have already begun to provide. Such special treatment must not place U.S. energy prices at levels substantially above our competition in world markets. And such special treatment must not be based on illusory deficit reduction that takes as much revenue from the Treasury as it provides.

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[1] Included as Attachment 1 hereto is a letter from the members of the ad hoc Coalition Against Energy Taxes to President Reagan and the joint Congressional leadership, expressing opposition to new energy taxes or fees as part of tax reform or deficit reduction. The many industries represented in that Coalition illustrate the sectors that could be harmed most by oil import fees.

We, as marketers, are an integral part of the domestic petroleum industry; we need a strong and thriving domestic industry. We support use of the tax code to guarantee a strong domestic producing and refining sector, including preservation of the intangible drilling cost deduction. However, we oppose legislation that would maintain prices at OPEC-created levels, thereby conferring huge windfalls on oil and gas producers and refiners.

II. OIL IMPORT FEES WOULD SERIOUSLY HARM THE ECONOMY

A. Adverse Macroeconomic Effects

Oil import fees protect the domestic oil and gas industry at an enormous cost to the economy. Studies of the macroeconomic impact of fees or tariffs on imported crude oil uniformly conclude that the national economy would suffer substantial losses. There is no doubt that economic growth would be impeded; it is estimated that a $10 fee would cause a decline in GNP from 1.0 to 2.6 percent.2/ Equally certain,

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2/ See Consumer Federation of America, "The Energy, Economic and Tax Effects of Oil Import Fees" (October 25, 1985), Table ES-1 at p. iv, included as Attachment 2 ("CFA Study"). For the purposes of macroeconomic analysis, it is irrelevant whether a $10 fee is imposed entirely on crude oil, or partly on crude oil and the remainder on

[Footnote continued]

unemployment would increase by up to 600,000,3/ and inflation would increase by up to 2.6 percent.4/ The precise magnitude cannot, of course, be projected, but the conclusion is clear: an oil import fee will impose a substantial drag on the U.S. economy.

The magnitude of this drag is not lessened by the current decline in the price of crude oil. The recent decline in oil prices does not reduce the burden to the economy from oil import fees, it simply alters its absolute and psychological effects. No matter what the price of crude oil, a $10 oil import fee will eliminate 1 to 2 percent of GNP growth, and add 1 to 2 percent to the rate of inflation.5/ Moreover, such a fee will create a shock to all consumers, by increasing prices for oil products and competing fuels by about $.24 per gallon.

[Continued from previous page]

petroleum products. The critical fact is that petroleum product prices would rise by about $10 per barrel, or $.24 per gallon.

3/ *See* Attachment 2.

4/ This inflation impact is measured by the change in the Consumer Price Index. *See* Attachment 2.

5/ Thus, if falling oil prices help to generate GNP growth of 4 percent, an oil import fee would reduce the growth rate to 2-3 percent. If GNP was only expected to grow by 1 percent without an oil import fee, the fee will likely cause a recession. In fact, each of the seven major oil price increases since World War II has been followed within nine months by a recession.

Just as oil import fees burden the economy, decreases in oil prices produce a substantial positive effect on growth. The recent decline in crude oil prices has led to a boom in both the stock and bond markets, interest rates are declining, and economic analysts are uniformly increasing their estimates of economic growth.6/ American consumers are already beginning to enjoy the benefits of lower oil prices in their home heating oil bills and at the pump. By increasing oil prices to last year's levels, an oil import fee would rob the economy of this powerful engine for growth, which may be the most positive economic force in more than 20 years.

B. Minimal Deficit Reducing Effects

Oil import fees would not only inhibit growth induced by falling oil prices, but would also counteract the deficit reducing effects of falling oil prices. As a result, estimates of the deficit reducing impact of oil import fees are highly exaggerated in a time of falling oil prices. Those who claim that a $5 oil import fee will generate $8 billion in revenue include only its direct revenue impact; they fail to consider the lost revenue to the Treasury from slower growth and the substantially greater government expenditures caused by higher oil prices.

6/ See, e.g. Washington Post, February 16, 1986 at G5. New York Times, February 19, 1986 at A1, included as Attachment 3.

In 1983 and 1984, studies were conducted by the Department of the Treasury, the Department of Commerce, and the Congressional Budget Office. Each concluded not only that the U.S. economy would benefit significantly from a decline in oil prices, but also that the federal deficit would be reduced substantially. The Treasury analysis concluded that a 40 percent decline in oil prices would reduce the annual deficit by $6 billion to $10 billion and a 24 percent decline would yield an annual saving of $4 billion to $5.5 billion.7/ CBO stated that "a sizable and permanent decline in oil prices would have a very favorable effect on inflation and on economic growth in the United States, and would significantly reduce the projected baseline budget deficit. . . ."8/ CBO calculated that a permanent $8 per barrel reduction in oil prices would reduce the unified budget deficit by a cumulative total of $129 billion over five years.9/

7/ Treasury Department interagency study of falling oil prices, Chapter II, p. 2 (1983) See Attachment 4.

8/ CBO, "Economic and Budgetary Consequences of an Oil Price Delince -- A Preliminary Analysis" (March 1983) at p. 1.

9/ Id. at pp. 16-17. See Attachment 5. Significantly, declines in oil prices below $20 per barrel will generate substantially greater deficit reduction effects than declines above $20 per barrel, which were analyzed by CBO and Treasury. Declines above $20 produce a significant loss of windfall profit tax revenues to the federal Treasury, while declines below $20 produce almost no loss to the Treasury from windfall profit tax revenues. See Crude Oil Windfall Profit Tax Act of 1980, P.L. 96-223, I.R.C. Sec. 4989. Thus, the deficit reducing effects of a

[Footnote continued]

More recently, the Chairman of the President's Council of Economic Advisors estimated that a $10 per barrel decline in the price of oil would yield an increase of as much as 1 percentage point to economic growth.10/ According to the President's Budget, eliminating this growth would increase the deficit by rising amounts each year, from $7.2 billion in 1987, to $78.2 billion by 1991.11/ The total increase in the deficit would far exceed the total gross revenue that could be generated by a $10 fee over the entire five year period.

The precise effect of falling oil prices on the budget deficit from 1987 to 1991 may be difficult to project. But the direction and order of magnitude of these effects are clear: falling oil prices will generate significant increases in taxes, and will reduce federal outlays that are directly related to oil prices and that are tied to a cost of living escalator. Oil import fees will eliminate these benefits. In short, oil import fees will contribute little if anything to deficit reduction, and may actually increase the federal deficit.

[Continued from previous page]

decline in oil prices from $25 to $15 per barrel would be substantially greater than the effects of a decline from $30 to $20 per barrel.

10/ Testimony of Beryl Sprinkel before the Joint Economic Committee, February 6, 1986 at p. 35.

11/ See Attachment 6.

C. Inefficiency of Oil Import Fees as a Tax

1. Windfall to Oil Producers

The fundamental reason oil import fees contribute so little to deficit reduction is their inefficiency as a tax measure. Oil import fees tax only oil imports, which are only thirty percent of total U.S. oil consumption, and less than 12 percent of total U.S. energy consumption.[12] However, because oil imports are the marginal source of oil in the U.S., the price of oil imports establishes the price for domestic production of crude oil and natural gas liquids. Therefore, consumer prices for all oil products increase by approximately the amount of the fee. However, the Treasury obtains revenue only from the portion that is imported; accordingly, the predominant portion of the increased consumer expenditures for oil flow to domestic producers, not the federal Treasury. The CFA Study estimated that a $10 fee would increase oil prices by about $45 billion, while federal revenues would increase by only $12-29 billion.[13]

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[12] Petroleum accounts for about 38.6 percent of total U.S. energy consumption. See, e.g., DOE/EIA State Energy Data Report (May 1985) at pp. 14-20.

[13] This range assumes that an import fee will result in substantial increases in windfall profit taxes. The CFA Study assumes that a fee will increase domestic oil prices to levels above $24 per barrel, at which level windfall profit taxes would apply. Windfall profit taxes would not apply to increases in domestic crude oil prices from $15 to $20 per barrel; thus, federal revenues would increase less.

2. Windfall to Natural Gas Producers

The inefficiency of oil import fees is even more evident in the natural gas sector, where wellhead prices will rise and all of the increases in revenue will flow to producers. Many analysts ignore the direct effect of oil import fees on natural gas prices. However, the experience in natural gas markets during the past five years demonstrates, beyond question, that natural gas prices move in tandem with oil.[14]

Thus, if oil import fees are enacted, increasing the price of residual fuel oil to industrial and utility consumers, and heating oil to residential and commercial consumers, gas prices will rise to meet these higher prices. In fact, much of the gas sold in the U.S. today is sold under contract escalators based on the oil equivalent price, and many utilities actually have tariffs that require that the price of gas to large users be set at the equivalent price of heating oil.

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[14] From 1978 to 1982, natural gas prices rose significantly, despite controls on "old gas," to meet the higher price of oil. Then, as soon as oil prices began to decline in 1982-83, gas prices followed, first in the industrial sector, then in the residential market. Today, gas prices are effectively decontrolled, and marginal gas production sells for about $2.00 per mcf, or about $12 per barrel equivalent. There is a substantial excess of production even at this level, and there is little doubt that gas prices will decline further if oil prices are not controlled by import barriers.

Consequently, oil import fees would provide a massive windfall to the natural gas sector. The CFA Study estimates that the windfall from a $10 oil import fee would be approximately $25 billion.15/ Significantly, none of this revenue would be taxed as windfall profit, because the Crude Oil Windfall Profit Tax does not apply to natural gas production.16/

Unbelievably, an oil import fee would also provide a windfall to Canadian natural gas producers, from which imports have been increasing significantly. Competition from Canadian natural gas imports has contributed to the decline in domestic natural gas prices to about $12 per barrel equivalent. Many contracts for Canadian gas imports specifically tie the import price to the price of competitive oil products. Thus, an oil import fee will permit Canadian natural gas producers to increase prices for exports, with absolutely no benefit to the U.S. economy or the U.S. Treasury.

Any tax limited to imports necessarily provides this windfall benefit to the industry protected, and thereby performs inefficiently as a revenue measure. This inefficiency

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15/ See CFA Study at p. iii.

16/ See Crude Oil Windfall Profit Tax Act of 1980, P.L. 96-223. Of course, to the extent that these increased revenues result in increased net taxable income, natural gas producers will pay additional corporate income taxes.

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can be corrected only by taxing all domestic oil and gas production and natural gas imports. Although this broad-based energy tax would not alter the adverse macroeconomic effects of the energy price increase, it would multiply about five-fold the revenues collected.17/

3. Increases in Federal Outlays

Oil import fees, or energy taxes, are also inefficient because of their effect on federal outlays. Every analysis of oil import fees concludes that outlays will increase substantially. Primarily, outlays will increase for petroleum products and related purchases, particularly by the Department of Defense; for programs with benefits indexed to a cost of living adjustment; for interest payments; for unemployment insurance; and for low income energy assistance. The Treasury analysis concludes that a reduction in oil prices of $8 per barrel will yield a $10 billion annual decline in federal expenditures;18/ the CBO analysis projects savings of $110 billion over 5 years from a similar $8 decline in oil prices.19/ The combined effects of oil import fees on federal

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17/ Oil imports represent approximately 12 percent of total energy consumption; total oil and gas consumption account for about 60 percent of national energy use. *See, e.g.*, DOE/EIA, *State Energy Data Report* (May 1985).

18/ *See* Attachment 4.

19/ *See* Attachment 5.

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revenues and expenditures demonstrates its gross inefficiency as a revenue raising measure.

D. Trade Effects of Oil Import Fees

Some proponents have suggested that oil import fees would produce significant benefits to the U.S. balance of trade. To the contrary, an oil import fee would not significantly reduce the U.S. trade deficit. Instead, it would create serious trade problems for many U.S. industries. Petroleum imports accounted for approximately $48.3 billion of the U.S. trade deficit last year, and the amount has decreased continuously from $75.6 billion in 1981. During this period, the petroleum component of the U.S. import bill has declined from 28.9 percent to about 14 percent.20/ Clearly, the massive increase in the U.S. trade deficit has not been caused by oil imports. If no protectionist action is taken by the Congress, and the recent reduction in world crude prices is not immediately reversed, there will be further substantial reductions in the bill for petroleum imports in 1986, probably on the order of $15-$20 billion.

However, if oil import fees are enacted, the U.S. will impose on its domestic industries energy prices that are significantly higher than those paid by the rest of the industrial world. This differential will create a significant

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20/ *See* Attachment 7.

handicap to all energy intensive U.S. industries, such as chemicals, agriculture, steel, wood and paper products, mining and plastics. These industries will be subject to greater import penetration, and will have much greater difficulty competing in foreign markets.

The level of this handicap could be enormous. If oil prices stabilize at $15 per barrel, and a $5 fee is imposed on crude oil and a $10 fee on products, U.S. energy costs would be about 67 percent higher than world levels. If oil prices fall to $12 per barrel, and a floor price of $22 for imported crude is established, with an additional $3 per barrel fee on imported products, U.S. industrial energy costs would be more than 100 percent above world price levels. These examples illustrate the magnitude of the burden to domestic industries that would be created by the legislation being considered.

The quantitative harm to the U.S. balance of trade is speculative, but clearly energy intensive industries will be placed at a serious disadvantage vis-a-vis their foreign competitors. The damage to these industries would more than likely offset any modest reduction in the trade deficit resulting from decreased oil imports.21/ And these are the

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21/ If an oil import fee reduced the level of oil imports by 10 percent, for example, the trade deficit would decline by about $3.5 billion if oil prices stabilize at $15 per barrel.

industries on which we must depend to restore a positive U.S. balance of trade.22/

III. OIL IMPORT FEES ARE UNSOUND ENERGY POLICY

A. The Cost of Production is Well Below $22

S. 1997 would establish $22 per barrel as the "survival price" for domestic crude, and guarantee that price for every barrel produced. There is no evidence that any significant amount of domestic crude oil production cannot be marketed profitably for considerably less than $22 per barrel. The best indication of the true cost of world crude oil production will be the level at which market forces stabilize the price of crude oil. If oil prices decline to levels below the marginal cost of production, some production will be shut-in, thereby decreasing available supplies and tightening the market.

Today, although spot prices have fallen below $15 per barrel for some crudes, there is no indication that any producers are refusing to sell at this price. In addition, spot natural gas prices declined to about $12 per barrel equivalent, even before the recent decrease in oil prices; yet there remains a substantial surplus of domestic gas production seeking markets at this price. Thus, very little current

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22/ Indeed, the President announced on September 23, 1985 a Trade Policy Action Plan designed to expand free trade and open foreign markets to U.S. products. Oil import fees would seriously hamper these efforts.

domestic oil or gas production requires a price of $22 per barrel to be sold profitably; and the small amount that may require this price should not generate a windfall for the producers of much less costly oil and gas.23/

An oil price of $22 per barrel only seems reasonable in relation to the inflated oil prices of the past six years. In fact, prior to the second oil price shock in 1978-79, caused largely by the revolution in Iran and the aggressive pricing behavior of the Ayatollah, world oil prices were less than $15 per barrel.24/ Even these price levels were engineered by the OPEC cartel in 1973-74, when oil prices quadrupled from about $3 to $12 per barrel. Thus, a U.S. administered price for crude oil of $22 per barrel, or a product fee that raises oil prices to $25 per barrel, would legislate an oil price in the U.S. higher than that demanded by Saudi Arabia after the Arab Oil Embargo of 1973.25/ Few, if any, observers of OPEC's actions in the 1970's argued that these prices were cost-based.

23/ In fact, the cost of domestic oil production has declined significantly during the past four years. See Oil & Gas Journal, "Index shows drilling, completion cost decline" (Nov. 4, 1985), included as Attachment 8.

24/ In 1978, the average cost of crude oil imports was $14.57 per barrel. See, e.g., Energy Information Administration, Monthly Energy Review.

25/ Even worse, these inflated oil prices would apply only to U.S. consumers.

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B. Oil Import Fees Will Result in Uneconomic Production of Oil

It is impossible to quantify the cost of production for domestic oil and gas, because the cost varies from field to field and well to well. For this reason, any import fee or price floor will provide windfalls to some producers and deny profitable production to others.

However, it is certain that establishment of any price floor for domestic crude, or imposition of an import fee, will lead to production of domestic crude oil and gas that is not economic in the current environment. In effect, it would create incentives to drain America first. In the short run, this may decrease oil imports; but in the long run, this premature production will injure U.S. national security.

There is no energy security basis for increasing domestic crude oil production today. The world is awash in oil. U.S. import sources are secure and diverse. Only 8 percent of U.S. crude oil imports now derive from Arab OPEC. The principal suppliers to the U.S. are Mexico, Canada, the United Kingdom, Venezuela, Nigeria and Indonesia.26/ These are the countries that have made the investments and commitments that have created the surplus in world crude markets; yet these are the countries that would be injured most by a U.S. oil import fee.

26/ See Attachment 9; and CFA Study, Table ES-3, included in Attachment 2.

Oil import fees will guarantee a profit for domestic oil production that would otherwise be uneconomic. Consequently, U.S. reserves will be drained at a time when there is no security threat; these reserves will be unavailable ten or twenty years from now when the world oil market may present a threat, and these reserves, if available, could then be used to prevent or temper supply shortages. Thus, overproduction today could lead to energy security problems in the future.

C. There is No Basis for a Higher Import Fee on Petroleum Products

1. Effect of Fees on Petroleum Products

If a determination is made that import fees on crude oil are necessary, despite their gross inefficiency and adverse effects, an equivalent fee must be placed on all imported products, so that there is no incentive to import products that are less expensive than products refined domestically. However, there is no legitimate basis for fees on imported products significantly higher than fees on imported crude; and such a differential would seriously injure competition in the petroleum market.

If higher fees are placed on imported products, the effect on consumers would be the same as higher fees on all petroleum imports, since the price of domestically refined products would rise to the price of the marginal import. Thus, a fee of $5 per barrel on imported crude oil, and $10 per barrel on imported petroleum products, would create the same macroeconomic burdens as a fee of $10 per barrel on imported crude oil. However, even less revenue would be raised than from a fee of $10 on crude oil. A fee of $5 on crude oil and $10 on products would apply the $10 level only to product imports, which are less than 35 percent of total petroleum imports; only the $5 fee would apply to the remaining 65 percent of crude oil imports. In addition, a differential fee on crude oil and products would split the windfall to the domestic industry between producers and refiners, thereby diminishing the revenues that could be used by producers for exploration and development.

An import fee differential of $5 per barrel would rovide the domestic refining industry with a revenue increase f about $70 million per day, amounting to about $25 billion er year. A comparable windfall would be bestowed on the natu- al gas industry, which competes with petroleum products, not ude oil. An import fee differential of $3 per barrel for troleum products would generate approximately $15 billion in itional revenues for refiners.

2. Refiners Do Not Need Protection from Imports

Domestic refiners have not demonstrated the need for tection from imports, particularly on such a massive scale. fact, imports of petroleum products in 1985 were iderably lower than the levels of product imports during almost every year of the 1970's, and were below the levels of 1984.27/ Other than residual fuel oil, the highest import penetration for any petroleum product in 1985 was 6.7 percent for distillate. This is hardly cause for alarm compared to the import penetration problems faced by other U.S. industries. Moreover, if no import fees are placed on crude oil, refiners will benefit significantly from the recent decline in crude oil prices, which will permit higher margins for refiners. Thus, before import fees are even considered for petroleum products, the current experience of refiners with lower crude oil costs should be fully evaluated.

3. Adverse Effects on Marketers

Fees on petroleum products that are in excess of fees on crude oil would be particularly damaging to independent marketers, who must depend on the availability of economically priced imports as a source of competitive supply. The availability of refined product imports induces competitive behavior by domestic refiners, particularly when domestic supplies are tight. If product imports are inhibited by fees, there will be little check on monopolistic and discriminatory pricing by refiners. Many independent marketers will be unable to compete, and the competitive force provided for so long by independent marketers will be eliminated.

27/ Attachment 10 provides a summary of U.S. petroleum product imports since 1970.

IV. REBATES TO HEATING OIL CONSUMERS WILL NOT WORK

Each of the bills under consideration purports to provide an exemption, or a rebate, for fuel oil used in home heating. We, as heating oil marketers, know that these schemes will not effectively eliminate the burden that oil import fees place on the nation's 14 million home heating oil consumers. Moreover, any such program is destined to result in a complex scheme of exemptions and entitlements that creates more problems than it solves. The complex, regulatory bureaucracy required to administer the oil price control program under the Emergency Petroleum Allocation Act of 1973 28/ should serve as a lesson to those who think any program of price supports can be implemented simply.

First, it is illusory to exempt imported home heating oil from import fees and expect that heating oil prices will not rise. On an annual basis, less than 200,000 barrels per day of heating oil is imported, yet winter distillate consumption averages well over 3 million barrels per day. Almost all of the home heating oil used on the East Coast is domestically refined.

If heating oil is exempt from import fees, much greater amounts would be imported, because the cost of domestically refined product would have to reflect the higher price

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28/ 15 U.S.C. Section 751 *et seq*.

of crude oil in the U.S. Refiners will, to the extent possible, curtail production of distillate. However, it is highly unlikely that imports would supply nearly all of the demand for heating oil, because the increased demand from offshore refineries would increase the price of the imports. Ultimately, heating oil imports would increase, domestic reginers would suffer and heating oil prices would increase to reflect partially the fee on domestic crude oil.

Second, it is impossible to require refiners to pass through the fee on products other than home heating oil. This form of cost allocation was tried, and failed, in the 1970's under the Emergency Petroleum Allocation Act. Even if it were possible, it would require a comprehensive scheme of refiner pricing regulation.

Third, it is impractical to provide refunds to home heating oil consumers. Refunds through the income tax system would fail to cover many of the poor and elderly who do not file returns, and could miss millions of renters completely. Moreover, there will be reluctance politically to provide refunds to oil heat consumers but not to consumers of other fuels for home heat and other essential users. It is also clear from the experience of the past five years that low income energy assistance programs will not be adequately funded, despite the best of intentions, and that funds often will not reach consumers in time to pay for necessary expenditures.

Fourth, there will be other sectors and industries that claim, and may merit, special protection. For example, to avoid discrimination against the Northeast, industrial and utility consumers of residual fuel should be exempt, as should manufacturers of petrochemicals for export. Any system of exemptions or rebates will require a regulatory bureaucracy, much like the one that was dismantled in 1981. This is a high price to pay for eliminating gross inequities, yet it will be necessary if import fees are imposed.

V. CONCLUSION

From 1973 to 1981, the U.S. sought to control the maximum price of crude oil and petroleum products. The experience was a dismal failure, acknowledged by most of its proponents. It did not insulate the U.S. from higher world oil prices, but it did create enormous distortions and inequities among producers and consumers, some of which were rectified by complex regulatory and entitlement programs. This experience will be repeated if the U.S. seeks to control the minimum price for crude oil and petroleum products through import fees.

Even if questions of equity and administration could be resolved without complex regulation, which is unlikely, the system would not work. Oil has become a commodity, and to control the price of any commodity, one must control production.

For more than 40 years, the production of crude oil in the world was controlled, first by the Texas Railroad Commission, then by the major oil companies, the so-called Seven Sisters, then by OPEC, and most recently by Saudi Arabia alone. However, Saudi Arabia is unable to control world production, and crude oil prices are now driven almost entirely by market forces. Spot sales of crude oil represented only 10 percent of transactions in 1973; now spot sales account for about 50 percent of all crude oil traded. A futures market for crude oil and petroleum products has emerged, bringing thousands of buyers and sellers to the bargaining table, virtually forcing the price to respond to market forces.

Without the ability to control production, and hence the world price, there is no basis on which to predict the burdens that an import fee or a floor price would impose on the U.S. economy. At the levels proposed, U.S. energy costs could be twice that paid by the rest of the world. The harm to the U.S. competitive position in world trade could be enormous.

Equally important, there is no sound reason for denying to the American economy and its consumers the benefits of lower oil prices that will be enjoyed by the rest of the industrial world. These benefits will not only spur investment, employment and growth, they will also lead to substantial reductions in the federal deficit.

As with any commodity, oil prices will be cyclical and unpredictable, and hence investment is risky. Special tax treatment for oil and gas production should be continued, in recognition of this risk and as an incentive to explore and produce. In addition, targeted assistance to areas heavily impacted by falling oil prices should be considered. However, a program of protectionism that could cost the American economy $50-$70 billion per year in increased energy costs, stifle the boom that has begun, and contribute only minimally to deficit reduction, is not sound economic or tax policy. It should be rejected.

Thank you.

Venezuela, to Bolster Its Oil Sales, May Buy Refiners in U.S., Europe

Wall St 11-29

By Roger Lowenstein
Staff Reporter of The Wall Street Journal

Like most oil-exporting countries in these times of oil glut, Venezuela has more petroleum to sell than customers to sell it to. To guarantee that at least part of the market will be there in the future, Venezuela has decided to buy some of its customers, such as gasoline marketers and refiners, in the U.S. and Europe.

Thus Petroleos de Venezuela, the state oil firm, is negotiating a joint venture with Nynaes Petroleum, a Swedish refiner, according to Petroleos officials. The oil company, the world's 20th largest oil concern, with sales of $13.6 billion, also has looked at some assets of Chevron Corp. and is studying other companies in the U.S. and Europe.

"There are quite a number of candidates," Julius Trinkunas, a director of Petroleos, said in a telephone interview from Caracas.

Assuring a Market

"The main objective is to assure a market for our crude. We have a shut-in production capacity of 900,000 barrels a day."

U.S. oilmen say there is something ironic about Petroleos going offshore. It was just 10 years ago, they note, that Petroleos was created when Venezuela nationalized the 14 foreign oil concessionaires operating in its territory.

Venezuela still hasn't fully paid the compensation that it agreed to pay at the time; payment has been held up by a back-tax claim initiated after the nationalization. Aware of what can happen to foreign-owned oil firms, the Venezuelans say they are being cautious about where they invest.

"We want to invest in countries where our investment will be respected for the long term," says Humberto Penalosa, a Petroleos official in New York.

Petroleos has hired consulting firms Arthur D. Little and McKinsey & Co. to work on an acquisition strategy. "There's a growing trend of producers going downstream," says John Sawhill, a director with McKinsey and a former deputy secretary of the Department of Energy. Kuwait, he notes, bought out the European marketing operations of Gulf Corp., now a unit of Chevron Corp. "Producing countries are very anxious to make sure they have outlets in a crude-long world," he says.

Returning to the Past

Venezuela had a guaranteed outlet for its crude before the nationalization. Its biggest concessionaires, Exxon Corp, Royal Dutch/Shell Group and Gulf, pumped Venezuelan crude into their world-wide marketing systems.

Petroleos's acquisition strategy would reintegrate production and marketing, much as the Venezuelan industry was before nationalization. That wouldn't be a complete surprise, given that the state-owned firm still is almost entirely run by former local executives of Exxon, Royal Dutch and Gulf.

Petroleos made a trial investment overseas two years ago, buying a 50% share in a West German refinery owned by Veba Oel AG. "We think it's worked out very well," Mr. Trinkunas says. "We have a sure outlet for 100,000 barrels a day. Not all of that crude would have an outlet elsewhere."

Venezuela has so much oil that it has curtailed exploration efforts. Its 28-billion-barrel reserves would last about 50 years at the current rate of production. Beyond that, Venezuela harbors what is probably the world's largest supply of heavy crude—the 1.2 trillion barrel Orinoco Oil Belt.

Venezuela, which has a production quota under the Organization of Petroleum Exporting Countries of 1.6 million barrels a day, sells about half its oil to the U.S. But many of its traditional American clients have disappeared in the merger wave of the 1970s and '80s.

Possible Joint Venture

"Venezuela has been selling to independent marketers along the U.S. East Coast," says Leonard Steuart, president of Steuart Petroleum Co., a Washington, D.C., concern that has had discussions with Petroleos regarding a possible joint venture. "A lot of Petroleos's clients have been acquired by companies with their own production."

Another advantage of buying assets in consuming countries is that it would enable Venezuela to circumvent OPEC. By selling to its own refineries, Venezuela could secretly discount its crude.

However, both oil refineries and gasoline outlets are in oversupply, and neither look like attractive investments. "If I were the Venezuelans I'd have a tough time deciding whether I wanted to tie up capital like that," says George Keller, chairman of Chevron Corp. "You're talking about a major investment and continuing cost commitment."

[illegible] AVAILABLE

STATEMENT OF ROBERT L. BRADLEY, JR., RESEARCH SCHOLAR, CITIZENS FOR A SOUND ECONOMY, HOUSTON, TX

Senator WALLOP. Mr. Bradley.

Mr. BRADLEY. Thank you, Mr. Chairman.

My name is Robert Bradley, Jr., and I represent Citizens for a Sound Economy, a 250,000-member citizens group based here in Washington, DC.

I think it is important to point out at the outset that unlike other consumer groups that have become well known by actively promoting oil and natural gas price regulation in the last decade, Citizens for a Sound Economy sees free-market pricing, not regulated pricing, as in the consumers best interest. And I think recent history has proven that regulated prices have served consumers very badly in energy markets.

From the vantage point of free-market consumerism, CSE strongly urges the current proposals to increase tariffs on oil and oil products be rejected. This is not because CSE is unsympathetic to those individuals, companies, and communities whose well-being depends on energy prices above which buyers and sellers are presently willing to transact.

It is because the world oil market has ushered in a new reality that can be ignored only at a cost to America that far exceeds the special interest benefits. What is at stake with a $5 per barrel tariff on crude oil and an equivalent product tariff is up to 12 cents a gallon for every automobile driver, residual fuel oil user and heating oil consumer in the United States, minus, of course, any exemptions.

A rough estimate of additional aggregate expenditure by energy users is $20 billion per year, and indirect cost from lost jobs and lower national wealth would add to this total. This is a tax, moreover, that hits poorer persons relatively harder than more affluent individuals. Compared to deficit reductions of $8 to $9 billion per year, this is an unaffordable price to ask the public to pay.

To put this viewpoint in strong language, Congress is advised not to become the new OPEC by increasing foreign oil prices where the cartel could not. The oil price cycle is running its course with the previous excesses being reversed. Just because $39 a barrel oil—at its 1981 peak—is down to $15 to $20, and maybe down to $10 to $15 by now, does not mean that something is terribly wrong that Congress must redress. Adjusted for inflation, $15 per barrel oil is still 150 percent higher than oil prices in the early seventies and very lucrative when compared over the 125-year history of oil prices in the United States. In other words, let us put this in perspective.

And I would add that the tragedy that the oil industry is going through right now is not because prices are so low but because prices got so high a few years back. And that was primarily due to ill-advised regulation on oil prices, natural gas prices, and the allocation of these products.

In my full written statement I have analyzed four arguments for oil tariffs—national security, unfair competition, temporary stabilization, and conservation and import independence—and find each one of them highly unpersuasive. The national security argument, in particular, is highly speculative and contradicted by the decentralization of the world petroleum market away from OPEC and Saudi Arabia in particular. I also criticize the revenue argument for tariffs. I see the fiscal problem is on the expenditure side, not the revenue side.

I think it is important also to consider the dynamics of a tariff program itself. Not once to my knowledge has any proponent of oil protectionism mentioned the experience of the Mandatory Oil Import Program, which began in 1959, to prop up domestic prices on national security grounds. It began with no exemptions, but was rather quickly overcome by so many that it became a model of economic inefficiency and the dangers of politicization.

The Bentsen proposal begins with a heating oil exemption for households, but I wonder how long it will be before charitable institutions, farmers, low-income groups, diesel motors—and remember diesel fuel is equivalent to home heating oil—and other groups join the bandwagon.

In the meantime, scarce economic resources will be wasted by all the different industry subgroups trying to get the best out of the program. Such is the inevitable result if the oil industry is put back on a political basis for the first time since oil price and allocation decontrol in early 1981.

In conclusion, the consumer and the U.S. industry in general deserve a world oil price after a decade of financial hardship. Congress should not intervene to take it away from them and at the same time, open up a Pandora's box with a new regulatory program. The sooner the energy industry adjusts to the new reality of the world petroleum market, lastly, the stronger it will be over the long run. Reality should not be temporarily obscured by tariffs for these reasons.

[The prepared written statement of Mr. Bradley follows:]

C/S/E

TESTIMONY OF

ROBERT L. BRADLEY, JR

FOR
CITIZENS FOR A SOUND ECONOMY

BEFORE THE

SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

UNITED STATES SENATE

FEBRUARY 27, 1986

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Current proposals for an oil import fee threaten the incomes of consumers and the strength of the economy. Since 1980, only modest tariffs on crude oil and petroleum products have separated U.S. oil buyers from the lower world price, but two groups want to change that. One group is the Independent Refiners Coalition (IRC), formed in late 1984 to seek substantially higher gasoline tariffs. The other group consists of federal lawmakers, particularly those from oil states, who see tariffs as politically expedient to give relief to constituents and as a revenue source to close federal budget deficits. The IRC includes virtually the entire independent refiner population; the entire membership of the American Independent Refiners Association and all but two independents in the major-company dominated National Petroleum Refiners Association. At the forefront is Ashland Oil, whose Chairman John Hall has proclaimed: "While I am a strong believer in free trade, I feel even stronger about fair trade."[1]

The unambiguous effect of oil tariffs is to expand the public sector at the expense of the private sector and leave the great majority of citizens poorer in the process. Econometric simulation models agree that GNP would fall by nearly one percent and up to 400,000 jobs would be lost from a major tariff.[2]

On an individual level, oil consumers would face the dilemma: go without or pay more for what is purchased. If a $5/barrel levy was fully passed on to consumers, they would pay nearly $.12/gallon more for gasoline, heating oil, and other petroleum products. At the 1985 level of consumption, the average family of four would spend approximately $300 more per year for gasoline and petroleum distillates such as home heating oil. In addition, higher prices would be paid for many goods which oil is used to produce.[3] If the tariff succeeds in cutting imports to 75 percent of their 1985 level, over $9 billion would be paid in duty.

But this would understate the cost to consumers. In addition to other costs such as independent service station closings which would reduce competition and convenience, consumers of oil substitutes such as coal, nuclear energy, hydroelectric power, and natural gas would face higher prices. Many natural gas contracts, for example, are indexed to the price of fuel oil in the same market area. Higher prices for the latter automatically increase prices for the former. Moreover, these higher prices have the effect of a regressive energy tax. Poorer citizens, many of whom own less energy-efficient homes and automobiles, pay a larger fraction of their income than the rest of the population.

The large revenues anticipated by advocates of the oil import fee are unlikely. In addition to its administrative costs, there are negative dynamic effects upon the economy, which imply a revenue loss and increased expenditures on unemployment and social welfare programs. It has been estimated that a $5/barrel import tax would only reduce the deficit on average $8.6 billion in each of the next three years.[4] Based on the 1983 level of oil consumption, this means that an additional $20 billion will be spent yearly on fuels in order to reduce the deficit by $8.6 billion. This is an unaffordable price to pay to give federal lawmakers a small bit of overspending relief and to benefit a subgroup of the oil industry favoring protectionism.

For those who would argue that the tax would just offset oil price declines and therefore not effect the general economy, it should be noted that the real cost is the forgone lower prices and consequent economic benefits. A tariff imposed during falling prices may be hidden -- and politicians can be expected to like that -- but its negative effects are the same as if tariffs plainly raised prices. It should be appreciated, furthermore, that the price declines being experienced are undoing the price escalations of the 1973-1981 period fostered by OPEC and counterproductive U.S. oil price and allocation regulations. Tariffs to slow or reverse the price decline are prematurely ending the cycle and shortchanging consumers. Remember: consumers went through a painful decade of high prices, and $15/barrel oil in 1986 (or adjusted to $7.50 per barrel in 1973 dollars) is still an increase of 150 percent increase from $3/barrel in 1973.

Lending protectionist support to the IRC, although not advocating tariffs for public relations reasons, is Texaco. In a letter to stockholders dated March 12, 1985, Chairman John McKinley complained about a "flood" of oil products from built-for-export foreign refineries. "Serious injury to both the economy and national security," he concluded, "can only be avoided by conscious policy decisions."5 Another industry party publicly supporting oil protectionism is Hughes Tool Company, whose drill bit business has been severely depressed by falling energy prices. "The wide disparity between the cost of producing a barrel of oil in Saudi Arabia and the cost of producing a barrel any place else in the world," stated Chairman J.R. Lesch, "makes the idea of equal competition ludicrous."6

Lawmakers from oil states have entered to debate with full force. Proposals to tax imported oil at $5/barrel and higher have been offered by, among others, Senators Lloyd Bentsen (D-TX), David Boren (D-OK), Robert Dole (R-KS), Malcolm Wallop (R-WY), and Gary Hart (D-CO). Unlike the refiners who have gasoline tariffs of $2.50/barrel and higher in their sights, Congressional interest is for comprehensive crude oil and oil product tariff increases to generate revenue and to spread the protection around.

Fortunately, industry protectionists and tariff-for-revenue proponents have run into organized opposition, and thus far oil tariffs have remained at levels set in the 1950s.7 The IRC has found an able adversary in the Marketers Coalition Against Import Restrictions, formed in April 1985 by the Society of Independent Gasoline Marketers of America, the Independent Gasoline Marketers Council, the Empire State Petroleum Association, the New England Fuel Institute, and the Independent Fuel Terminal Operators Association. These independents, in either the product import, wholesale, or retail sectors, see higher tariffs as a direct threat to their ability to compete against the major oil companies. Cheap supply sources for downstream independents are a foil to the cost economies of major-company integration, and access to abundant foreign gasoline will not be surrendered without a political fight. A cross-section of independent oil producers, interestingly, have joined their marketing counterparts to oppose oil import tariffs. Reversing their historic support of protectionism, a task force of the Independent Petroleum Association of America (IPAA) concluded that "any action which would appear to benefit the industry in the short run could inflame those legislators desiring to change the tax treatment (i.e. percentage depletion, intangible drilling costs) of the industry."8 Finally, major companies such as Exxon, Mobil and Shell and their trade association, the American Petroleum Institute, support the free trade position, although until recently they have been less vocal against protectionism than independent marketers and importers.

Congressional interest in oil tariffs has been counterveiled by President Reagan. Until last August, protectionist bills in the House and Senate were debated in committee, but only one reached a vote--a Senate defeat by 78-18. Just prior to the August recess, however, the Senate Budget Committee, led by Pete Domenici (R-NM), forged a deficit reduction plan that included a $5/barrel tariff on crude and oil products to raise $25 billion as part of a three-year, $338 billion revenue package. Although opposed by northeastern Congressmen and other legislators sensitive to consumer prices, only Reagan's unequivocal rejection of tariffs as a tax increase prevented lawmakers in a compromising mood from seriously considering the fee.

The new year promises other tries at an oil tariff. Senator Boren, believing that "recent drops in the world crude market and future prices make the need for such a fee clearer," plans to reintroduce his oil import fee proposal in late February.9 Senators Bentsen and Wallop expect to hold adjoining hearings on a proposed "excise tax" to be set at the amount the imported oil price is below the "minimum survival value" domestic price of $22/barrel.10

Oil Protection in Review

Oil protection is not new. In the 1860s, crude and product tariffs raised revenue to defray Civil War expenses and to promote development of the Pennsylvania-Ohio-New York oil region. Unlike today, industry opposition was not present and consumers were not heard from. Countervailing tariffs from 1897 to 1919 were followed by a free trade period until 1932. In that year pressure from independent oil producers, aligned in the recently formed IPAA, led Congress and President Hoover to enact a $.21/barrel tariff on crude oil and product tariffs over $1/barrel. State and federal regulation had been struggling to keep crude prices near $1/barrel, but now "dollar oil" was here to stay.

Tariffs were reduced in the 1939-1952 period for friendly nations such as Mexico and Venezuela. In the early 1950s, however, growing imports and increasingly restricted domestic production pursuant to major oil state--except California--proration programs (whereby oil production was limited to a price-stabilizing "market demand") renewed a protectionist urgency not seen since the 1930s. A voluntary program to reduce imports in 1954 and again in 1957 failed, and in 1959 independent producers and coal interests persuaded President Eisenhower to begin the Mandatory Oil Import Program (MOIP). Ostensibly justified on national security grounds, the program froze or rolled back crude and product imports to keep marginal domestic production afloat and provide incentive to add new domestic reserves in case the U.S. should suddenly be called upon to meet its own demand. Previous tariffs remained. World War II and the Cold War, combined with industry opportunism, created the "fortress mentality" behind oil protectionism.

In its 14 years, the MOIP became thoroughly politicized and could scarcely meet any definition of national security. The Cabinet Task Force on Oil Import Control concluded in 1970:

> The fixed quota limitations . . . and the system of implementation that has grown up around them, bear no reasonable relation to current requirements for protection either of the national economy or of essential oil consumption. The level of restriction is arbitrary and the treatment of secure foreign sources internally inconsistent. The present system has spawned a host of special arrangements and exceptions for purposes essentially unrelated to the national security.11

The infamous story of the MOIP has been told elsewhere,12 but its general failure is illustrative of what happens when special interests substitute politics for sound trade policy. Its lessons should not be forgotten in the current debate.

President Nixon replaced the MOIP and long-standing oil tariffs in 1973 with license fees, and in 1975 President Ford added supplemental fees. These taxes were not protectionist but were conservation and national security oriented. Tariff reductions beginning in 1976 culminated in a decision by President Carter in April 1979 to temporarily abolish tariffs to stem looming shortages. The next year tariffs, pursuant to the General Agreement on Tariffs and Trade, were reactivated and have remained since. The 1986 levels of tariffs per barrel, last amended in 1952, are shown below.

Oil Type	Most Favored Nation	Communist Nation
Crude Oil (above 25o)	$ .0525	$ .21
Crude Oil (below 25o)	$ .1050	$ .21
Kerosene/Naphtha	$ .1050	$ .21
Lubricating Oil	$ .0008	$1.60
Gasoline/Jet Fuel	$ .5250	$1.05
Natural Gas/N.G. Liquids	Free	Free

Taxation versus Fiscal Reform

In a real sense tariff proposals are not being considered because they are good for the American people but because they raise government revenue in a time of unprecedented fiscal constraint. The Gramm/Rudman/Hollings amendment will force many difficult decisions in 1986, and perhaps the most important will be that over true fiscal reform (spending cuts) or increased taxes. Temporary and burdensome measures, like taxing imported oil, only prolong the current fiscal crisis. Federal spending between 1982 and 1985, a relatively non-inflationary period, grew by 29 percent or $213 billion. At the same time, taxes were up 19 percent or $119 billion.13 The answer to our fiscal problems is to get spending under control, not to raise taxes. Increased taxation is not "reform." It only perpetuates the current problem.

Fiscal problems abound at the state level as well, especially in oil states like Texas, Oklahoma, Kansas, Alaska and Louisiana. Indicative of their concern over falling oil tax revenue, the Oklahoma Senate passed a resolution asking Congress to pass an import fee. Louisiana is flirting with legalized gambling, and Texas is nervously looking at new forms of previously verboten taxes. Ideas of a state lottery are gaining popularity in Kansas. And Alaska, for the first time in recent history, has reduced its state budget. Thus the debate over import fees reflects the saga of government at the fiscal crossroads.

These oil states have become used to swollen oil revenues in the last decade and need to return to, at a minimum, fiscal normality. According to the IPAA, state severance and production taxes increased from $685 million in 1972 to $6.6 billion in

1984, an almost 1000 percent increase. Between 1979 and 1984 alone, this state revenue source jumped 267 percent. So tax revenue cannot be blamed for fiscal problems at either the federal or the state level. Thus, the oil import tax cannot be considered the answer. It only delays the ultimate day of reckoning when spending will finally have to be cut.

Arguments for Protectionism: A Critique

To impress upon lawmakers and the public the need for higher tariffs, the Independent Refiners Coalition has resurrected the national security argument and added a new one alleging unfair competition. The national security argument in particular deserves detailed comment and refutation. It was successfully employed to obtain the MOIP in the 1950s, and its success will help determine whether an oil protection program is adopted in 1986. A third argument criticized below is a justification for standby temporary tariffs in the event of an international oil price war. A final argument scrutinized below is that tariffs, by raising energy prices and reducing imports, would benefit the nation through conservation and import independence.

1. National Security

The current version of the national security argument is as follows.14 The IRC notes that over 100 refineries representing 15 percent of U.S. capacity have closed since 1981. While it is admitted that many shutdowns involved small inefficient refineries built in the 1975-1980 period to reap regulatory rewards, more recent shutdowns beginning in 1983 involved efficient refineries as well. The "second wave" retrenchment is directly linked to gasoline imports, which doubled from several years before to reach six percent of domestic consumption. With heavy losses in 1983 and 1984 threatening even the strongest independents and higher imports expected from for-export refineries under construction, the argument continues, more closings could push national refining capacity below the "national security" level estimated at approximately 14 million barrels per day. The IRC argues that with this vulnerability, OPEC, which is shaping up to be the major for-export refining source, would be able to do with gasoline in the 1980s what it did with crude oil in the 1970s. An effective U.S. response cannot turn to the $15 billion Strategic Petroleum Reserve (SPR), which contains unrefined oil, or new refining capacity which requires years to construct; it must depend on internal capacity to meet internal needs. In fact, the IRC argues that adequate capacity must be large enough to refine SPR oil--an argument which makes refineries as vital to national security as the nation's crude oil inventory.

The IRC has also emphasized that many small independent refineries vulnerable to imports are geographically dispersed and situated near military installations for which specialized products are distilled. It is claimed that the present configuration is more likely to efficiently serve military needs in an emergency than fewer more distant refineries are.

The national security argument has long been questioned by scholars in the oil and gas field, and with justification it will continue to be. Many facts of the current import situation and the world petroleum market suggest that oil imports are not and will not be contrary to national security. Study of previous petroleum crises, indeed, suggest that government policies, not free market processes, were at fault.

The historical inspirations of oil protectionism are World War II and the crude oil import disruptions of 1973-74 and 1979. During the war, the U.S. oil industry strained to meet military and civilian needs. Although war theaters were adequately supplied, oil shortages on the home front were experienced. In the 1970s, crude cutoffs led to gasoline lines and large price jumps. Petroleum self-sufficiency, it is concluded, is required to avoid a repeat of these experiences, which means supplementing free trade in petroleum with import management.

This historical foundation of oil protectionism is flawed. Since the mid-1920s, there have been abundant supplies of crude and oil products *except for periods of major government petroleum regulation*. It was precisely from 1941 to 1945 and 1971 to 1980 that price controls, allocation controls, and general government planning in petroleum were in place. The lesson to be learned is not that national self-sufficiency must be legislated, but that government intervention can turn--and has turned--market challenges into serious threats to the national well-being. Import

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restrictions to artificially enlarge domestic industry are a governmental response to a government-created problem which fail to address the source of the difficulty.

The world petroleum market in the 1980s has evolved in ways which make the national security argument more speculative than ever before--and virtually obsolete. As vividly demonstrated by the plight of OPEC in market share and influence, the world oil market has become increasingly diversified. Mexico and Canada, not Saudi Arabia, are the leading exporters of oil to the U.S. Fully 67 percent of U.S. product imports originate with America's OECD allies, U.S. possessions, or U.S.-owned refineries in the Caribbean. Seventy-six percent of product imports originate in this hemisphere.[15] Almost two-thirds of U.S. crude oil imports come from Europe, the western hemisphere and the Far East.[16] Even the fragile travel lanes of Persian Gulf oil are becoming diversified. In place of tanker transport through the Strait of Hormuz, a vast network of oil pipelines is spreading across the Middle East to lessen the risk of transportation disruption. Combined with less exports *per se*, the non-communist world's supply of oil passing through the Strait of Hormuz has dropped from 41 percent to 15 percent in the last decade.[17]

Spot markets and trading networks have proliferated in recent years in place of long-term contract sales. The world market has become so complex and interrelated that there is serious question whether nation-to-nation embargoes can be effective in restricting supply and raising price. In the 1970s, only 3.5 percent of international oil was sold on spot markets; today it is believed that over 40 percent of foreign production is spot. Artificial constraints on oil movements create profit opportunities, and new trading patterns and import/export substitutions can offer effective replacement to any geographical region. As prohibition demonstrated, where there is demand there is supply, despite the best efforts of government to prevent it. The same will be true if selective countries try to embargo oil to the U.S. unless the structure of the world petroleum market reverts radically to that of a bygone era, a highly unlikely occurrence.

National-security protectionists must assume *many* embargoes and *many* foregone profit-maximizing trading opportunities to isolate the U.S. from the world market. Simple reference to an emergency and an embargo are not enough; when-where-how much scenarios based on recent-past configurations or anticipated configurations are required to offer a convincing case for protectionism. This, however, is very difficult to provide because of the complexity and secrecy of the world oil market. How can anyone chart future U.S. foreign policy, its relative effects on different oil regions, the source of embargoes and their longevity, U.S. preparedness, import substitutions by friendly countries, embargo circumventions by wily traders, and so on? The shroud of simplicity behind national security protectionism is really a veil of ignorance. Worst-case scenarios to make a case for protectionism are extremely speculative.

Current details of the gasoline import situation suggest that stability and serenity are far more likely than chaos in the foreseeable future. Gasoline imports are equal to only six percent of U.S. consumption, which hardly compares to crude oil imports that peaked at 50 percent in the 1970s before falling to current levels of 29 percent. Approximately 30 countries have recently exported gasoline to the U.S., led by (in order of October 1985 amounts) Venezuela, the Netherlands, Canada, Virgin Islands, Saudi Arabia, Spain, and Brazil. West Germany, Romania, Italy, United Kingdom, Turkey, India, and China have also been major gasoline exporters to the U.S. This variety, both geographically and politically, offers a substitution capability that would nullify the effects of any embargo. When it is further realized that the strong dollar was in part responsible for the recent import surge, which was still a small fraction of U.S. consumption, it is difficult to see a present problem or ominous trends.

The IRC asserts that virtually all current operating capacity is necessary for national security. The 14 million barrels per day suggested minimum is intended to blanket the status quo, which would include even the smallest and most unsophisticated domestic refiner. This is special-interest reasoning; one could hardly expect the IRC to admit that any of its members was dispensable. Non-members, such as major company refiners, are generally state-of-the-art and poised for the long haul.

Some small, less efficient refiners are still candidates for shutdowns. Many refineries under 50,000 barrels a day with little downstream capacity to make light products such as gasoline remain. The "second wave" of 26 refinery closings included 14 which had no downstream capacity, and only three plants were above 50,000 barrels per day. (Optimum size is considered above 100,000 barrels per day, and gasoline is the bread-and-butter product of refineries.) The "second wave" of closings, in short, may still run its course with new victims not unlike earlier ones.

A crucial--yet unmentioned--cause of the refinery shakeout is oil conservation. Oil consumption in the U.S. has dropped over four percent from 1981 through 1984 (and over 16 percent since 1979), and a smaller pie affects refineries of all sizes. A further decline in U.S. oil consumption in 1985 from a year earlier suggests that refinery overcapacity may continue to be revealed--and that the IRC estimate of necessary refining capacity is already obsolete.

There are other problems with the suggested national security refining minimum. The Department of Energy estimated operable (operating or potentially operable) refining capacity in early 1985 at 15.6 million barrels per day with actual operating capacity of 14.6 million barrels per day. This estimate would seem to suggest that by the IRC's own criteria there is room for more shutdowns without jeopardizing national security. With an abundance of other fuels, including 1.5 million barrels per day of natural gas liquids production and surplus natural gas, which is a direct substitute for residual fuel oil in many industrial markets, there is ample room for lower refinery capacity without concern about over-adjustment.

All of these criticisms of the IRC's national security argument point toward a more fundamental one--the illegitimacy of a national security optimum separate from market activity. No one can systematically know what the future will bring better than entrepreneurs with their financial livelihoods at stake. Short of perfect knowledge, oil protectionists who hark as national energy planners must give way to market forces to determine--and continually revise--the quantity and configuration of refinery capacity. In such an "unplanned" predicament fluctuating oil prices will equalize supply and demand to avoid shortages. And inventory management, conservation, and other adjustments during import disruptions will minimize price jumps. Market processes, not government direction, are consonant with the national wellbeing.

The contention that dispersed refineries located near military installations promote national security is another status quo argument tailored to the interest of IRC members. It neglects the function of entrepreneurs to decide what is efficient and necessary. If the present configuration of refineries is unprofitable and the military is paying going prices for fuel, then obviously resources would be better allocated by transferring market share to more efficient plants elsewhere. The military will continue to get what it pays for with efficiency gains to the economy.

2. Unfair Competition

While national security is the main argument for oil protectionism, a second argument familiar to other industries seeking import barriers has been adopted by the IRC: "unfair" foreign competition. Two complaints of unfair competition are aired. One is that refineries subsidized by foreign governments provide unfair competition against U.S. refiners. Without environmental restrictions and particularly by receiving crude feedstock at discounts within the state-owned integrated structure, for-export refineries in oil regions can overcome depressed product markets and high transportation costs to vigorously compete in the U.S. The second complaint is that other nations' oil import barriers, such as Japan's oil product import ban, artificially direct exports to the U.S. market.

Complaints of unfair competition are the refuge of the desperate competitor. It is not so much an intellectual argument as it is an open admission of entrepreneurial misjudgment. To win profits in an open trade situation is to correctly anticipate the domestic and foreign market. Decisions by oil-exporting regions to substitute oil product tanker shipments for crude oil tanker shipments is a logical and planned economy that investors in domestic refineries should have taken into account.

Foreign government subsidization of U.S. consumers is open to debate. To the extent it actually occurred, it is a positive event that is quite the opposite of an embargo. But are crude discounts really a subsidy? Official OPEC crude prices, until the December 1985 policy change, were widely regarded as too high, and the big move into refinery construction and flexibly-priced product exports is recognized as a way to market oil that may be unmarketable in unrefined form. The discounted crude price may in fact be the market-clearing price, but as a transfer price between affiliates it is a bookkeeping entity that is ultimately irrelevant compared to the _final_ product price.

Independents have long accused majors of unfair competition from transfer pricing decisions. They are actually attacking the flexibility of integration. Those burdened by integrated competition are free to integrate themselves by expansion or merger. Complaints about too much competition are not enough.

Petroleum diverted to the U.S. because of import barriers in other markets is fortuitous to U.S. consumers. It is also a fact of the world market that successful entrepreneurship must recognize. It is a matter for foreign consumers to lobby to reverse; it is not a matter for increased U.S. protectionism which hurts domestic consumers and sets a nationalistic tone in world oil markets to invite retaliation.

3. Temporary Stability

A third argument for protectionism emanates not from the IRC but from academia. Professor S. Fred Singer, a respected energy analyst, has proposed a standby variable oil import fee (VIF) should the fragile OPEC alliance give way to a price war from open-flow production.18 Singer estimates that prices could fall well below $25 per barrel to a low of $10-$12 per barrel, which would wreak havoc with many investments in the U.S. oil industry. The effects of such a price decline on natural gas, other energy substitutes, and energy-related businesses would be similarly severe. Based on the conviction that the price war would be temporary, Singer's variable fee is intended to bridge the gap until normality returns. Singer's stabilization plan is also seen as encouraging energy conservation and thus leading to lower prices in the (undefined) medium and long run.

The VIF, like the national security argument, is highly presumptive. Short-run consumer welfare is readily sacrificed for dubious longer-run benefits. Singer is betting-on-the-come and seems to forget that the market--through spot prices, contract prices, and 18-month futures prices--also anticipates long term prices in present price quotations. If market participants expect a price war to be temporary, their rush to purchase "cheap" oil will send present prices toward the expected longer term price. Decisions concerning industry assets will discount the present and bank on higher future prices. But if those whose financial fate is at stake do not agree with Singer's predictions, Singer takes on the role of an infallible energy czar who believes his knowledge must intervene to prevent market failure. Whatever Singer's past success in the oil forecasting sphere, it would be a terrific gamble to implement a VIF. Not only could the market be right and Singer be wrong, but political expediency could wreck even the best-laid utilitarian plans. Singer and other supporters of transient tariffs based on counter-expectations are advised to take their confident knowledge to the futures market and gamble with their wealth, not the fuel bills of many millions of U.S. consumers.

4. Conservation and Import Independence

Another argument for oil tariffs is a throw-back to the Carter era when ideas of energy exhaustion, price inelasticity of demand, and OPEC invincibility were in their heyday. The argument is that less energy consumption and import independence are ends in themselves, and higher prices via an import fee are really positive for consumers by reserving secure supply for the future. Some economists have given this position a formalistic basis by calculating an "import premium," the difference between the actual import price and the higher "true" import price of incorporating the negative trade balance and likelihood of supply cutoffs. A tariff, then, is justified as bringing the two prices together to eliminate the "negative externality" under free trade in petroleum.

This argument has always been theoretically suspect, and the events of the 1980s have shattered its credibility. Energy is not short but in surplus for the foreseeable future. The OPEC price war, the growth of non-OPEC oil reserves and production, the U.S. gas bubble, and the overhang of shut-in Canadian gas point toward an abundance of energy not seen in this country in decades. Energy efficient technology has buttressed individual will to make demand responsive to higher prices. Fundamental supply-demand adjustments to OPEC pricing decisions by the world oil market have left the cartel without a means to repeat its past successes. In light of this new reality, it is pointless to ask for consumer sacrifice for their own good. There is no negative externality to undo; the out-flow of dollars for foreign oil will be recycled to buy U.S. exports or make investments in the U.S. which reverse the trade balance, and oil embargoes are highly unlikely if for no other reason than they will be ineffective. The actual import price, in sum, is the "true" price.

The above pro/con arguments are based on a view of the future. The 1980s experience makes the conservation/import independence view the far more speculative of the two. Given such doubt, it is unwarranted to side with those who would cause short-run injury in hopes of long-run good.

The Case for Unrestricted Trade

While protectionist arguments rest on speculative assumptions and arbitrary complaints about world petroleum conditions, pro-trade arguments rest on certainties and likelihoods. Unrestricted trade means more supply and lower prices for U.S. consumers. It allows U.S. firms to enjoy lower costs to increase profitability, spur economic growth, and enhance competitiveness in world markets. The petrochemical, steel, agriculture, and transportation industries particularly benefit from open oil markets. Alternative-fuel users also benefit from lower oil prices. Free trade in oil works to keep coal, gas, hydroelectric power, and nuclear prices competitive.

Open trade promotes industry competition. Independents-versus-majors has been a competitive tiff since the Standard Oil Trust days, and now that downstream independents have discovered a low-cost (imported) supply to rival the advantages of integration, it should not be taken away. (The economic ability of independents to compete against majors is another reason to repeal anti-consumer federal and state regulation at the gasoline wholesale/retail level designed to advantage inefficient non-integrated service stations. Such regulations include divorcement, divestiture, franchise protection, and below-cost laws.)

Free trade preserves domestic oil for its rightful time of consumption. Protectionism artificially stimulates domestic industry and promotes over-consumption of domestic oil. Drain

America last, not first, should be a rallying cry for trade advocates who can rightly raise the banner of national security in their favor.

Open trade promotes national security in other ways. The opportunity to sell oil in the world's largest consumption market encourages foreign producers to seek new reserves and to construct new refineries and oil-transportation assets. This enlarges and diversifies the world market. The approximately 30 countries that already export gasoline to the U.S. offer protection against cutoffs; enlarging this number would increase our options.

Open trade also establishes goodwill in the world oil market. It should not be forgotten that Venezuela, encountering export reductions because of the Mandatory Oil Import Program, called the first meeting in 1960 of what became OPEC. A major tariff today could give foreign oil centers an issue around which to forget their deep differences and better cartelize major non-U.S. areas of crude production and/or refining.

Free trade eliminates the need for political control of oil imports. A major regulatory program and associated bureaucracies are avoided, and impersonal market forces replace political decisions and liability. The entire literature of the IRC and the many speeches and press clippings of new protectionist proposals scarcely mention the last national security/protectionist oil import program--the Mandatory Oil Impor

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Program. This episode, which proved to be a Pandora's Box of regulation, should be a warning of the high price of sacrificing unrestricted trade to special interests.

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CONCLUSION

The Independent Refiners Coalition and other industry constituencies for higher tariffs are no more patriotic than the rest of the industry and consumers; these tariff advocates have threatened investments and have used the most politically effective argument to justify their pecuniary interest. Academics such as Singer who claim to know the future better than market participants are pretenders to a knowledge that only the collective market can "know." Arguments for conservation and import independence have become obsolete as a result of world oil market developments. Arguments for oil protectionism should be rejected, and recognition of the time-honored benefits of free trade should be substituted.

The case for unrestricted trade extends beyond rejection of higher tariffs to save consumers up to $20 billion in increased energy expenditures. It points toward eliminating existing tariffs on oil and oil products listed in the table above. Now that the oil industry and politicians have opened up the tariff issue, net oil-consuming state congressmen, with across-the-board consumer support, should seize the initiative to repeal existing duties. Existing duties are not large enough to arouse fierce opposition, and the industry division could be used to advantage. As pro-consumer issues, oil tariff reform and lower energy prices are politically opportune.[19]

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A final word on the current debate is reserved for Congress. Despite the problematic case for tariffs, legislators have been and will continue to be partial to protectionism as a revenue source. As President Reagan correctly reiterated, high spending and not low taxation is the problem behind the federal deficit. The job of Congress is to reduce expenditures deeply and comprehensively to get the fiscal house in order. A regressive tax on energy consumers such as the oil import fee has no positive role to play in fundamental reform.

APPENDIX

Post-Implementation Problems

Implementing an oil tariff will be like opening a Pandora's box. Whatever the motivation for doing it, one's problems have only begun. For starters there is the problem of decreasing exports from countries dependent on oil revenues to repay U.S. banks. Leading the list of debtor oil-exporting nations are Mexico ($97 billion), Venezuela ($25.5 billion), Indonesia ($22.9 billion), Egypt ($16.4 billion), Nigeria ($12.7 billion), and Columbia ($12.6 billion). Could these nations use tariffs to declare force majeure, default, and threaten the financial integrity of major U.S. banks? This would put regulators in a position of exempting certain countries which would create inequities and lead to new problems and complications. (Back in 1959, the MOIP was only six weeks old when overland exports from Mexico and Canada were exempted which began the political ball rolling.)

Another question is natural gas. Oil prices are driving down gas prices, and growing Canadian exports are exacerbating the situation. Independent producer groups are already protesting applications and filing lawsuits against new Canadian gas proposals. Are legislators prepared to restrict gas imports for the same reasons as restricting oil imports?

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Another implication of oil protectionism is the ability of oil states to reintroduce market-demand proration. A tariff removes the discipline of foreign competition on domestic production which would give Texas, Oklahoma, Louisiana, Kansas, and New Mexico room to set market-demand factors below 100 percent as in the 1930-1972 period. Both major oil protectionist programs of this century, the 1932 tariff and the 1959 quota, were inextricably linked to wellhead proration. Is Congress prepared to set up oil states to restrict domestic production?

The Bentsen proposal to exempt heating oil from tariffs creates its own problems. This invites foreign refiners to maximize fuel oil production which will hurt less sophisticated domestic refiners who cannot make gasoline instead. This sort of effect led to small refiner subsidies in the last decade. A problem of inequity is also created because Southwest consumers, who purchase much more gasoline than fuel oil, pay the full tariff while Northeastern consumers, who consume more fuel oil than gasoline, escape the brunt of the tariff. Residual oil users also pay the full tax. Congress should brace itself for inter-fuel lobbying battles and regional conflicts therein.

We know that a tariff on oil would create some major problems, and there are many more that cannot be predicted because of the complexities and unknown political turns the program will take. They can be avoided by keeping the lid shut on the oil version of Pandora's box.

STATEMENT OF DR. LAWRENCE GOLDMUNTZ, PRESIDENT, ECONOMICS AND SCIENCE PLANNING, INC., AND CHAIR, NATIONAL ENERGY COMMITTEE, AMERICAN JEWISH COMMITTEE, WASHINGTON, DC

Senator WALLOP. Dr. Goldmuntz.

Dr. GOLDMUNTZ. Thank you very much, Mr. Chairman. It is a pleasure to appear before you.

I am chairperson of the American Jewish Committee's task force on energy. We have proposed that the United States support the proliferation of the production of energy resources, domestically and internationally, the deregulation of oil and gas, conservation and an oil import tax.

The rationale for support of an oil import tax is national security. We do not ask the private sector to buy F-15's. We cannot ask the private sector to protect us against manipulation of a commodity that enters into our economy as broadly as oil.

We heard a great deal this morning about elasticity. Dr. Greenspan spoke about people not ripping insulation from their walls, and, therefore, perhaps consumption will not increase quite as much as one might expect if prices fall.

On the other hand, there are other anecdotes that one might tell. For example, railroads, at one point, were interested in converting their diesel locomotives to coal if you could only show a 3-year payback. Today, they are not interested if you can show a 1-year payback. So there are many anecdotes on both sides of the elasticity issue.

I have tried to use some numbers that are midway in the estimates of elasticity both on production and on consumption. When those numbers were plugged into my computer, there were the following results, which seem terrifying.

If oil stays at $15 a barrel for 5 to 10 years, oil imports will increase to approximately 250 percent of today's level. That is a level of 11 to 12 million barrels a day.

If oil stays at $20 a barrel for 5 to 10 years, then the increase in imports will be to only—and do we really mean only—200 percent. That is, something like 9 to 10 million barrels a day.

While this is occurring, what happens to demand in the rest of the world? If oil prices are low, not only does U.S. consumption increase, but world consumption increases. And if you assume that world consumption increases at the same rate as U.S. consumption, which is probably not correct—probably world consumption will increase more rapidly—ask yourself how long will it take before the current excess capacity of OPEC is consumed. And what comes out, which is even more terrifying, is that just at the point when U.S. imports get up to these astronomical levels the excess capacity of OPEC disappears and they are back in the saddle and prices skyrocket. And we are back exactly in the position that we were faced in 1979.

Now roller coasters are great for kids, but they are dreadful for economies. And just to remind us what the last peak in oil prices cost the world economy, let us refer to the International Energy Agency's estimate. They estimated that 1 year of the crisis of 1979 cost the economies of the OECD countries $1 trillion, and substantial inflation and substantial unemployment from which we are just now recovering.

We certainly don't want to get back into that situation. The best way to avoid it, is to put a tariff on oil. It may or may not be revenue neutral. It may harm some of our allies who are oil exporters. It may affect certain oil-consuming sectors of the economy. But that is all of secondary importance to the national security issue associated with another oil shock of the dimensions that I have just outlined.

If we are to conserve oil in the broad sense—that is fuel switching, out of oil to gas, coal, and other resources that we have—as well as lower consumption where oil is necessary, the overall mechanism for doing that is through price manipulation. If you do not do it that way, you have to do it by detailed regulation, and that has not worked out very well in the past.

Therefore, we support the imposition of an oil import now. We supported it 10 years ago.

In answer to Senator Bradley, if the Congress did not support it a number of years back, why should they support it now—well, with all due respect to this organization, perhaps they should have done it a few years ago and perhaps they should do it now.

Thank you very much.

Senator WALLOP. Thank you, Dr. Goldmuntz.

[The prepared written testimony of Dr. Goldmuntz follows:]

Testimony of

THE AMERICAN JEWISH COMMITTEE

OIL IMPORT TAX
S. 1997 and S. 1507

U.S. SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

Presented by

Dr. Lawrence Goldmuntz
February 27, 1986

The American Jewish Committee
165 East 56th Street
New York, N. Y. 10022

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My name is Lawrence Goldmuntz. I am President of Economics and Science Planning, Inc., and Chairman of the Energy Committee of the American Jewish Committee (AJC). AJC is a national organization of approximately 50,000 members which is dedicated to safeguarding the civil and religious rights of Jews and to the advancement of fundamental freedoms for all people. It is concerned with a wide range of public policy issues. AJC has been involved in energy issues since 1972. AJC's Energy Committee, among whose members are leading energy analysts, was organized at that time in response to the economic and security threat to the U.S. arising from OPEC's activities and oil embargoes.

Since 1972, AJC has urged the U.S. to encourage energy production domestically and abroad as well as to promote conservation. Its policies have been consistent with protection of the environment. In particular, we have supported fuel economy standards, gas and oil deregulation, the use of fuels alternative to oil and an oil import tariff to accomplish all these objectives with a minimum of intervention in the marketplace.

U.S. dependence on imported crude and oil products is likely to increase in the 1990s and beyond. Lower international oil prices are already resulting in decreased domestic exploration and lessened incentive to conserve or switch fuels. This will only exacerbate U.S. dependence.

Imports are projected to increase substantially to about 50 percent of total consumption by the early 1990s, a situation that led to the oil shocks of the 1970s -- endangering national security.

The oil import tax is the single most important measure available to the U.S. to minimize the possibility of another oil shock before the end of the next decade. While there are substantial proven and probable reserves in many parts of the globe, there does not seem to be much oil left in the U.S. Approximately 1.2 wells have been drilled per square mile of sedimentary basin in the U.S. However, only 0.02 wells have been drilled per square mile in the rest of the world. This results from the relative security of U.S. investments as compared to the rest of the world where expropriation is common, and it continues despite the relative poor prospects for discovering additional domestic reserves.

For example, investment in exploration and production in the U.S. was approximately $37 billion in 1983, a region that comprises only 5 percent of the world's prospective oil-bearing area. In the rest of the world, containing 95 percent of the world's remaining prospective areas, only $37 billion was invested in 1983.

The U.S. has only 28 billion barrels of proven reserves left and consumes 5.5 billion barrels annually of which approximately one-third

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(4.5 million barrels per day) is imported as crude or product. In recent years, the finding rate of domestic oil has approximately matched consumption; however, this finding rate is going to decrease due to the substantial reduction in exploration budgets caused by the collapse in oil prices. Before the collapse in oil prices, the Congressional Research Service predicted a reduction of from approximately 9 to 29 percent in U.S. oil production in the year 2000 as compared to 1982. The reduction in U.S. production is likely to be even more substantial than predicted since oil prices have dropped approximately 35 percent since the date of that projection.

Furthermore, consumption is bound to increase as oil prices decrease. We can see evidence of this in the relaxation of Corporate Average Fuel Economy Standards (CAFE), the purchase of larger automobiles, the slowdown in conversion to fuels other than oil in all segments of the economy.

The combination of the decrease in domestic production and increase in consumption is going to lead to an import level of 8-10 million barrels per day probably within the next decade, and almost certainly by the year 2000. This level of imports exceeds those prior to the oil shocks of 1978-79. Oil imports today -- at one-half this projected level -- account for one-third of the U.S. trade deficit. The economic stress and national security exposure of imports at double the current level is extraordinary. Furthermore, a weakening dollar may convince OPEC to accept only a market basket of currencies -- rather than dollars -- for oil purchases which would further weaken the dollar and further increase the cost of oil imports to the U.S.

The imposition of a substantial oil import tariff, which would increase over a few years, would maintain U.S. conservation and fuel switching efforts and, thereby, diminish our need for imports. A tax on imports is preferable to a tax at the gas pump, since gasoline sales represent less than 50 percent of petroleum use. Fuel switching and conservation are probably more feasible in many non-automotive petroleum requirements, and a tax at the pump is not effective in these areas. Even at the $10-$20 per barrel tariff level, U.S. gasoline prices would still be considerably less than those of our trading partners in the OECD. These trading partners have complained over the last decade that we were the largest importers of oil and had the lowest gasoline prices and that the U.S. was inhibiting a unified approach to OPEC.

There are some aspects of an oil import tariff that are secondary to the national security aspect. Should the tariff be revenue neutral? If it is imposed, should there be a corresponding reduction in a similarly regressive tax such as the social security tax? Should a comparable tax be applied to domestically produced oil? If there were a tax on domestic oil, there would be no incentive to maintain domestic production. If there were not -- at least to a certain extent -- some would complain of a windfall for domestic producers. While these issues are important, their resolution is not central to AJC's arguments for the imposition of the tariff.

There is another important aspect of the oil import tariff. Since there is now a buyer's market for oil, and since it is likely to persist for some period, the cost of the full tariff will not be absorbed by the U.S. consumer. The oil producers will have to absorb a considerable portion of any tariff for as long as the glut persists. Isn't it wonderful to have a tax that somebody else helps to pay.

A tariff will cause some friendly oil producers hardships. There are ways to handle these problems on a hemispheric or bilateral basis. They are of concern but of secondary importance to the national security and economic consequences of not imposing an oil tariff.

The tariff should have been imposed some years ago. It takes time for an automotive fleet to turn over to more fuel efficient cars; it takes time to build a nuclear or coal plant; it takes time to switch industry out of oil. We do not have much time left measured in terms of the changes needed in our energy infrastructure before the next oil shock.

The American Jewish Committee, therefore, strongly urges a substantial tariff on imported oil, right now, as a national security measure.

If the U.S. does not take this action, then the country is faced with the less satisfactory alternative of providing tax incentives, tax credits and direct grants to increase domestic production, encourage conservation and promote fuel switching from oil.

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Senator **Wallop**. Just to ask you, Mr. Bradley and Mr. Steuart, what do you say to all three of the previous witnesses who did not agree on all things, as you recall, but did pretty well agree on the fact that the free market forces were not working in this market?

Mr. **Bradley**. Free market forces are working in the United States because there is not price regulation or allocation regulation on oil.

Senator **Wallop**. Well, that is only a miniscule part of the equation of the world energy price.

If there is flooding going on, that is scarcely free market.

Mr. **Bradley**. I think flooding is beneficial to consumers. I do not necessarily think OPEC is going to get right back in the saddle again because of irreversible changes in technology.

Senator **Wallop**. What irreversible——

Mr. **Bradley**. Which means that oil demand is down. Oil demand is down 17 percent since 1979.

Senator **Wallop**. And rising now rather rapidly.

Mr. **Bradley**. My statistics show that last year the demand for oil fell by one-half of 1 percent.

Senator **Wallop**. Let me ask you to comment on this, Mr. Steuart, and Mr. Bradley, both. In light of free market that the national average price of home heating oil in October was $1.03 and in November was $1.08 and is about that in January in the face of declining oil prices. Where is the consumer benefit?

Mr. **Steuart**. Mr. Senator, prices in the Washington area have come down $.20 in the last 4 weeks. They are under a dollar now, after peaking at $1.21 in the Washington-Baltimore market. I also see a further decline in those prices.

Senator **Wallop**. You have selected a market. I was talking about the national average price, which we just got from the Energy Information Agency. In October 1985, $1.03; $1.08 in November; and it is $1.08 in January.

Mr. **Steuart**. I cannot speak specifically of the areas in the Northeast. In the Washington-Baltimore market, the area of which I am most familiar, the price peaked at over $1.20 in early January and are down below a dollar now. We have seen a $.20 decrease in prices in a very short period of time.

To see why the prices have not come down faster, one must understand that in many cases the inventory that supplies this system was ordered in December or January, and is just now flowing through the system. One cannot translate a New York spot price instantaneously into a retail market. The inventory will flow through and impact those prices lagging somewhat. I would fully expect those prices to fall further throughout the season.

Senator **Wallop**. Can I ask you something? Because I was a little disappointed in your written statement. The several Finance Committee members—Senator Chafee and Senator Mitchell—who precisely recommended that you testify, indicated that you were an authority on the use of home heating oil. And they indicated that as such you would be able to talk about a heating oil exemption and suggest how to implement it.

Mr. **Steuart**. I do not think the heating oil exemption would work at all, Senator. I believe that it would have the reverse effect, by creating a demand for imported oil. My view is that if you were to exempt imported oil and there were a fee on products and crude, that that fee would be reflected in the cost of domestic production. Thus, you would have the adverse effect of creating a demand for imported oil.

Senator Wallop. So, then, their indication to the committee was incorrect. That you were not——

Mr. Steuart. I am not a proponent, sir, of a——

Senator Wallop. They had suggested that that was why they wanted you to testify before us.

Dr. Goldmuntz, this computer model is alarming. Is there anyway within modeling to get a comfortable handle on how long events like this might last. I know you have projected certain things for a 5-year period. Is there any comfortable price forecasting mechanism that says that is a likely scenario, an unlikely scenario, modestly likely scenario?

Dr. Goldmuntz. I think the simple answer to your question is not. The elasticities that I used were the average of those that are around for both production and consumption.

One of the things that has happened in the past 5 years is that we have been amazed at the elasticity associated with consumption. Nobody expected that we would cut back that.

So these numbers I don't think are excessive. And I think they are as believable as any numbers you can provide.

Senator Wallop. I agree with you. And I am constantly amazed at the reluctance of people talking energy policy to attribute any elasticity to it either from the reaction of producers to price or consumers to price. I think we have seen dramatic evidence that in both instances there is significantly less elasticity.

Dr. Goldmuntz. Look at the automobile advertisements. When have you last seen a TV ad for an automobile that stressed mileage as compared to performance, as compared to gas consumption, for example? And this has happened just in the space of the last 2 years when there has been relaxation in prices. It is going throughout the economy. I think those numbers are to be trusted, but nobody can guarantee them. I think the elasticities were stronger than we expected in the past 5 years, certainly on consumption, as prices went up.

Senator Wallop. I am concerned as well by some of the testimony of Dr. Hall, Dr. Greenspan, and others. In your modeling, what about the other economic effects? You tended to dismiss them as being less important than the economic or potential economic effects of roller coasters, as you stated.

But don't they make a case about what causes us to make those considerations before moving forward?

Dr. Goldmuntz. I don't believe so. And let me say why. Mexico's problems are more than exporting oil. Mexico was offered to the United States market at 441, a million Btu in gas during Dr. Schlesinger's career at the Department of Energy and they turned it down. They never completed those gas pipelines. Somebody in that government made a very bad judgment on behalf of their people.

Now we cannot protect them from bad government, bad economics in their own societies. We certainly have to do something because I understand the vulnerability of the banks and so forth. But that does not mean that we should distort policies that affect our national security.

Senator WALLOP. I did not phrase my question correctly. But I was less concerned about Mexico's problem than I was their balance-of-payments statements, their productivity statements, their cost-of-living statements and their general statements about the GNP.

Dr. GOLDMUNTZ. Well, there is no doubt that a drop in oil prices will increase GNP and decrease inflation. That isn't the only tool that we have to do that. There are others. And I don't think that a tool that is important for national security should be sacrificed on that particular altar. There are other ways to approach that problem. We have to approach that problem.

By the way, we have achieved an enormous amount of increase just at the $20 price. I am not talking about driving the price to $10. If you put in an oil import tax and gradually escalate it, the economy will adjust. That is what we are talking about. And you will not see quite the dire effect as if you assume that oil was at $25 a barrel and then dropped to $15, and that was the improvement. Some of these numbers on GNP improvement, like 2 percent, I think, are obtained that way. Let us start out with $28 a barrel, drop it to $15; what is the improvement in GNP? Well, it might be as large as Dr. Hall suggested.

But if you take more modest increments in both the drop or the assessments of the oil price level, I do not think you will see extremes of that sort.

With respect to New England, New England is bringing in power from Canada, and they will bring in more power from Canada that is not oil generated. It is about time that New England adjusted to the issue that oil in the United States is not as prevalent as it used to be. And it poses a national security problem. Yes; it will cause some problems in New England, but you cannot scramble eggs without breaking the shell.

Unfortunately, people are going to have to adjust to the fact that oil in the United States is not as profuse as it is in other parts of the world.

One statistic—the United States has 1.2 wells per square mile of sedimentary basin. The rest of the world has 0.02 wells per square mile of sedimentary base. We count our blessings when we hit a well of 100 barrels a day. The rest of the world thinks it is a disappointment when they hit 1,000 barrels a day.

Now that ought to say something to us. We are running out of this resource over some time scale. We had better adjust to it. And we had better adjust to it by ways that we have available. Some people are going to suffer. We hope they suffer slowly and in minute amounts. But we cannot postpone the transition from a society that had a profusion of oil to a society that does not without taking into account national security issues. We have to break those eggs.

Senator WALLOP. Well, thank you all very much. I appreciate your testimony, Mr. Steuart, Mr. Bradley, Dr. Goldmuntz.

The last panel consists of George Slocum, who is president and chief operations officer of Transco Energy Co.; Mr. James Phelps, an independent producer, and chairman of Special Task Force on

Petroleum Imports of IPAA; Mr. James Hunt, chief executive officer, Synergy Corp.; Mr. George Jandacek, vice chairman, Crown Central Petroleum in Baltimore; and Mr. Carl Bolch, Jr., president of Racetrac Petroleum.

Gentlemen, welcome. You have been very patient.

Mr. Slocum, if you would begin, please.

STATEMENT OF GEORGE SLOCUM, PRESIDENT AND CHIEF OPERATIONS OFFICER, TRANSCO ENERGY CO., HOUSTON, TX

Mr. Slocum. Thank you, Mr. Chairman.

I am president and chief operating officer of Transco Energy, which is a relatively large, diversified energy company headquartered in Houston, TX.

In the interest of time, I have tried to edit and simplify my remarks for the last 4 hours, and I could say a lot more, but if you do not remember anything, remember this one short message—there can be no reliable national security for America unless the economic viability of our domestic energy supplies is maintained.

Imported energy supplies must not be allowed to reach such high levels that their dependency, once again, threatens both our economy and national security.

I wholeheartedly support the imposition of a variable import fee as proposed by Senators Wallop and Boren as one means to achieve that goal.

As you have heard before today, we have now reached the point where oil imports are about only one-third of our needs. However, this level was achieved only because price increases encouraged the surge in domestic conservation and drilling in the early 1980's. A continuation of precipitous price declines that we have recently witnessed threatens to undo much of the progress that has been made.

These low prices will not provide sufficient incentive for new drilling nor justify continued operation of marginal wells.

On the demand side, significantly increased foreign supplies are becoming available and being sold, not only displacing domestic oil, but gas and coal as well. Our big boiler fuel customers have reported an increasing number of offers to replace natural gas with fuel oil cargoes priced at whatever it takes. There is also increasing evidence that coal sales or coal by wire, electric power, is being displaced by power generated from low-priced foreign oil, particularly at coastal cities.

Falling prices have already had a very negative impact on U.S. drilling activities. In December 1981, an average of over 4,500 rigs were at work in the United States. That number has now dropped to 1,308, representing over a 70-percent decrease. The rig count has dropped by 32 percent in just the last 2 months alone. Those idle rigs should now be at work exploring and developing the domestic energy reserves needed in the 1990's. Instead, the Nation will be relying on huge amounts of imported energy during the next decade unless we adopt more farsighted energy policies today.

It is impossible to predict the extent to which foreign producers are willing to drive prices down in order to wrest back the lion's share of the U.S. market. However, Professor Weinstein of Southern Methodist University suggests that the OPEC countries could profitably produce crude oil at prices of $6 to $7 per barrel. At such prices, U.S. drilling activity would come to a virtual standstill, demand would soar, and the levels of imports would approach 80 percent.

This possibility would not be so frightening if the suppliers were a diverse group. Unfortunately, however, two-thirds of the non-Communist world's proved reserves are located in the Middle East and controlled by members of OPEC.

Furthermore, production costs in the Middle East are extremely low compared to most basins in the United States. Consequently, major OPEC producers could continue to profitably pump crude at very low prices long after wells in other free world countries have been shut in and, of course, new exploratory and development drilling shot down. It would not be long before OPEC would once again have the upperhand on oil supplies and prices.

It has been suggested by some commentators that recent price declines do not truly represent the free market at work. As your colleague, Senator Nickles, pointed out in his January 30 statement for the Congressional Record, the price cuts represent calculated maneuvers by Government entities to increase their control over world market forces. Without a doubt, these governments are capable of knocking the price legs out from under us to recapture the U.S. market.

Congress should ask the Defense Department about the seriousness of rising levels of oil imports. What does the Defense Department think about import levels greater than 50 percent coupled with a domestic exploration and development industry flat on its back? Our Nation's defense runs on oil; not coal, natural gas, or nuclear energy.

It is only through the imposition of import fees that we can arrest America's return to dependency on foreign energy. I strongly suspect that much of the industry's opposition to import fees has already evaporated in the wake of recent price declines and will disappear if prices plunge to the $10 to $15 level.

I am sure that you are aware that today our proven crude oil reserves are only 75 percent of what they were as recently as 10 years ago, and they are going downhill.

Finally, if the Nation's lawmakers are still not inclined to tax foreign energy, at the very least, they should not compound the problem by further burdening domestic production with higher taxes under H.R. 3838.

Thank you.

Senator WALLOP. Thank you, Mr. Slocum.

[The prepared written statement of Mr. Slocum follows:]

Testimony of

George S. Slocum

President and Chief Operating Officer

Transco Energy Company

Presented to the

Subcommittee on Energy and Agricultural Taxation
Committee on Finance
United States Senate

on

S. 1997
S. 1507

February 27, 1986

Mr. Chairman and members of the Subcommittee, my name is George Slocum. I am President and Chief Operating Officer of Transco Energy Company, and I greatly appreciate the opportunity to address the Subcommittee on a topic that is so crucial to the long-term security of the nation.

By way of personal background, I am a graduate of Cornell University, with a Bachelor's Degree in economics and a Masters Degree in business administration. I was employed by Citibank in 1967, reaching the position of Vice President and Senior Credit Officer. Since joining Transco in 1978, I have served as Executive Vice President and Chief Financial Officer and assumed my present position in 1984.

Transco is a diversified energy concern headquartered in Houston, Texas. Our principal business operations include the purchase, transmission, and sale of natural gas in the Eastern United States; oil and gas exploration and production primarily in the Gulf Coast and Rocky Mountain areas; and the production and sale of coal in the East. So, one way or the other, our business energizes several of your home states.

The lesson of the 1970's is that there can be no reliable national security for America unless a firm control over our energy supplies is maintained. Imported energy supplies must not be allowed to reach such high levels that their interruption threatens both our economy and national security. We experienced the consequences of a lack of a national energy policy in the late 1970's. I support the imposition of variable import fees as proposed by Senators Wallop and Boren as one means to achieve that goal. However, I would recommend that the fee be imposed only for an interim period of no more than three years and reevaluated at the end of that time to determine whether it is still merited by national security concerns.

In 1977 the United States was importing almost one-half of our crude oil requirements. That heavy dependency made us extremely vulnerable as a nation to interruptions in supply, whether accidental or intentional. I am sure there is no need to remind the members of the Subcommittee of the gas lines and other economic shocks that accompanied the supply interruptions and foreign imposed price increases of the last decade. By simultaneously reducing demand through conservation and increasing domestic supplies through decontrol of domestic prices we have reduced our dependence on foreign oil throughout the first half of the 1980's. We have now reached the point where imports fill only about one-third of our needs.

However, this level was achieved only because price increases encouraged the surge in conservation and domestic drilling of the early 1980's. A continuation of precipitous price declines that we have recently witnessed threatens to undo much of the progress that has been made. Low prices will not provide sufficient incentive for new drilling nor justify continued operation of marginal wells. On the demand side, significantly increased foreign supplies are becoming available. Our big boiler fuel customers have reported an increasing number of offers to replace natural gas with fuel oil cargos priced at "whatever it takes." It is only reasonable to expect that similar displacements of coal sales are just down the road.

Falling prices have already had a very negative impact on U.S. drilling activity. In December, 1981, an average of 4,520 rigs were at work in the United States. That number has now dropped to 1,376, representing a 70 percent decrease. The rig count has dropped by 28 percent just since the start of 1986. Those idle rigs should now be at work exploring and developing the domestic energy reserves needed in the 1990's. Instead, the nation will be relying on huge amounts of imported energy during the next decade unless we adopt sensible energy policies today.

In the Department of Energy's publication, Annual Energy Outlook, 1984, it was found that imports could account for as much as 61 percent of total U.S. demand by 1995. This forecast assumed a decline in the average import price to $24.00/bbl by 1986 which in retrospect has quickly proved to be conservative.

It is impossible to predict the extent to which foreign producers are willing to drive prices down in order to wrest back the lion's share of the U.S. market. However, professor Bernard Weinstein of Southern Methodist University suggests that the OPEC countries could profitably produce crude oil at prices of $6.00 to $7.00 per barrel. According to Weinstein, at such prices U.S. drilling activity would come to a virtual standstill; demand would skyrocket; and the levels of imports would approach 80 percent. This possibility would not be so frightening if the suppliers were a diverse group. Unfortunately, however, two-thirds of the non-communist world's proved reserves are located in the Middle East and controlled by members of OPEC. Furthermore, production costs in the Middle East are extremely low compared to areas such as the North Sea. Consequently, major OPEC producers could continue to profitably pump crude at very low prices long after wells in other free world countries had been shut-in and, of course, new exploratory and development drilling shutdown. It would not be long before OPEC would again have the upper hand on oil prices and supplies.

It has been suggested by some commentators that recent price declines do not truly represent the free market at work. As your colleague, Senator Nickles pointed out in his January 30, 1986, statement for the Congressional Record, the price cuts represent "calculated maneuvers by Government entities to increase their control over world market forces." Without a doubt, these governments are capable of driving oil prices down to whatever level is necessary to recapture the U.S. market.

Some critics would have us rely totally on foreign producers as long as they hold down prices, and produce our own reserves only when foreign prices escalate to unacceptable levels. Unfortunately, as we learned in the 1970's, low domestic production cannot be turned around overnight. Many of America's independent producers and related oil service companies are already in precarious financial condition, and major companies are announcing capital expenditure cutbacks. Without them we will not be able to restore our domestic reserves to a secure level within an acceptable time frame. At the same time, we should be developing on a limited basis, not closing off, the technology to convert our sizeable resources of coal and shale oil to synthetic hydrocarbons. If we ever reached the point of importing 80 percent of our energy needs and a major supply interruption occurred, it would take years to restore domestic production to adequate levels. In the meantime, both the U.S. economy and national security would be severely, and perhaps permanently, damaged.

Furthermore, the cost of imported oil is already the biggest culprit in a very large federal trade deficit. You can imagine what the deficit might become in just a few years if imports rise to over 50 percent of oil consumption, and once again OPEC forces the price of oil to much higher levels. Such an enlarged trade deficit would have worsening economic consequences for the United States.

Congress should ask the Defense Department about the seriousness of rising levels of oil imports. What does the Defense Department think about import levels greater than 50 percent, coupled with a domestic exploration and development industry flat on its back? Our nation's defense runs on oil - not coal, natural gas, or nuclear energy.

The critics of import fees argue that they would disproportionately burden regions of the country that are heavy consumers of imports, specifically the northeast and midwest.

They fear that import fees would cause their energy costs to skyrocket, thus raising industrial production costs to non-competitive levels. This argument ignores the fact that the proposed level of import fees would be designed merely to prevent a precipitous and destabilizing price collapse.

Some recommend an increase in the gasoline tax rather than imposing fees on imported crude oil and refined products. Certainly such a tax would raise a substantial amount of new revenues and thereby help reduce the enormous federal deficit, but it does nothing to maintain an acceptable level of exploration and development of our domestic energy resources. The import fee does!

It is only through the imposition of import fees that we can arrest America's return to dependency on foreign energy. In doing so, we can send an important signal to OPEC that we have reached the point of no return on our goal toward substantial energy self-reliance. The energy policy decisions that are made today will determine our sources of supply and our national security in the next decade. I recommend that the fees be imposed on a trial basis for a period of no more than three years. This will allow the issue to be revisited at the end of that period to determine whether they are still necessary to preserve national security. If not, the fees should be allowed to expire. I am convinced that much of the historic opposition to import fees has already evaporated in the wake of recent price declines and will disappear if prices plunge to the $10-15 level. I am sure you are aware that today our proven crude oil reserves are only 75 percent of what they were as recently as ten years ago, and they are going downhill fast. If the nation's lawmakers are still not inclined to tax foreign energy, at the very least, they should not compound the problem by further burdening domestic production with higher taxes under H.R. 3838.

STATEMENT OF MR. JAMES PHELPS, INDEPENDENT PRODUCER, AND CHAIRMAN, SPECIAL TASK FORCE ON PETROLEUM IMPORTS, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, SAN ANTONIO, TX

Senator WALLOP. Mr. Phelps.

Mr. PHELPS. Mr. Chairman, I am James C. Phelps of San Antonio, TX. I am chairman of the IPAA Task Force on Petroleum Imports, that spent several months in 1985 making a detailed study of all import fees. We analyzed what we believed to be every conceivable argument in support of and in opposition to import fees as an element in public energy or tax policy. Our task force determined that the uncertainties and difficulties of applying an import fee as a means of aiding independent oil and gas producers far outweigh the potential benefits.

The seeking and granting of exemptions and favored treatment to various importers, processors, and consumers; the administrative costs and problems of confusion, disruption and corruption; the potential inequity of import fees on refiners and energy-consuming industries are just some of the many reasons which are detailed in our full statement. For this multiplicity of reasons, the association membership voted at its annual meeting in October to oppose an import fee, as either a protective or revenue device. This was reconfirmed by the IPAA executive committee just 3 weeks ago.

However, our conclusion that import fees are not a good solution must not be interpreted to mean the petroleum industry is without problems. Quite the contrary. All of its vital signs indicate desperate conditions that grow worse daily and great uncertainty for the future.

Government has contributed to this situation by its past actions and threats of negative actions. Our industry is now in the fifth year of a devastating economic shakeout. Since 1982, literally thousands of economic entities have been liquidated, including independent producers, drilling contractors, supply and equipment firms, and financial institutions.

The principal oil-producing States, whose government revenues are largely dependent on oil and gas prices and taxes, are confronted with monumental revenue shortfalls.

Petroleum exploration and development always has been cyclical, but nothing prepared us for the wild economic gyrations of recent years. In the upcycle from the mid-1970's through 1981, the industry expanded its activities at unprecedented costs covered by equally unprecedented debt obligations. Now, under threat of wholesale revision of historic energy tax provisions accompanied by precipitous declines in oil prices, many in the industry find their costs exceed their internal cash generation.

We are confronted with the certainty that tens of thousands of stripper and marginal wells will be plugged or abandoned this year. Each barrel of daily production loss will have to be replaced with an imported barrel. Also, hundreds of millions of barrels of recoverable reserves will be lost forever.

We are witnessing the most dramatic and sustained free fall in domestic petroleum exploration and development in the entire history of the industry. The uncertainty created by pending tax legislation has been a principal contributing factor. It is not just coincidental that we are now operating just half as many drilling rigs as were running in December 1984, just after the release of the so-called Treasury 1 proposal.

Our latest rig count of 1,308 is only 30 percent as many rigs as were operating in December 1981. At current levels of industry activities, an irreversible decline in domestic petroleum production will soon be evident and our import dependence will go from 35 percent today to some 60 percent in 1990, and we will again be at the mercy of OPEC both as to supplies and prices of energy.

Restoring a climate of confidence and certainty in the domestic petroleum industry is imperative to economic stability for all Americans and to the national security of our country. To halt this downward trend in the industry and avoid increasing the power of OPEC we urge, first, immediate adoption of a production maintenance provision to assure continuation, until the market stabilizes, of production from marginal properties; No. 2, restore percentage depletion for all domestic oil and gas production without limitations; No. 3, assure continued expensing of intangible drilling costs in the year expended or incurred; and modify the definition of intangible drilling costs to include geological and geophysical costs and unrecoverable surface casing; No. 4, eliminate price controls on natural gas; and No. 5, eliminate restrictions on the use and transportation of natural gas.

These are just the most urgent of an extensive list of positive changes Congress can make to help avoid the total collapse of the domestic petroleum industry.

Thank you very much.

Senator **Wallop**. Thank you, Mr. Phelps.

[The prepared written statement of Mr. Phelps follows:]

Statement of the
Independent Petroleum Association of America
before the
Subcommittee on Energy and Agricultural Taxation
# of the
Senate Committee on Finance

On the Issue of Taxing Petroleum Imports

February 27, 1986

Mr. Chairman, I am James C. Phelps, an independent oil and gas producer from San Antonio, Texas, I am appearing here today as Chairman of the Joint Task Force on Petroleum Imports of the Independent Petroleum Association of America which, for many months, has been investigating the potential effects of adopting a tax, fee or quota on imported petroleum. After very careful and detailed study, we have concluded that:

Protecting the economy and national security against an overdependence on foreign produced energy is in the national interest. Actions to prevent such overdependence are a legitimate concern of the federal government warranting, under extreme circumstances, intervention in the marketplace. However, taxes, tariffs, fees or quotas on imported crude oil or petroleum products would be counterproductive to the national interest at this time.

Imposition of any tax or quota on imported crude oil and/or products likely would be accompanied by some increase in taxes on domestic production. Any increase in tax on domestic production, for whatever reason, will be counterproductive, reducing both general economic activity and future domestic production. Such actions will, in the long-term, increase rather than reduce dependence on imported energy.

All proposed forms of import fees or tariffs would require creation of large new administrative bureaucracies and carry the probability of significant market distortions. Such distortions result in artifical entitlement and allocation programs which only compound, rather than solve, problems caused by market disorders or uncertainties.

Measures to control overdependence on imported energy are unrelated to issues concerning federal deficits. Government should not attempt to reduce budget deficits through taxes on imported energy or through any energy related taxes. Reduction of budget deficits should be accomplished by reduced spending.

Having stated our opposition to adoption of a tax on imports, which many would expect domestic producers to support, let me explain in some detail why we have reached this conclusion.

The recent history of the domestic petroleum industry has been a time of great turmoil. While all sectors of the industry have been affected, none has suffered progressive economic deterioration as great as independent explorer/producers and those who provide services and supplies for their operations. We are in probably the worst depression the domestic petroleum exploration/production industry has ever suffered. The rate of decline in exploration and drilling activity to find and develop new reserves has never been greater. It appears likely that we will soon drop below the previous record low level of drilling of 1971. The long-term impact on our nation's ability to protect against the almost certain future disruption of supplies of foreign produced oil, on which we are becoming dangerously overdependent, is frightening to contemplate. Many in the independent sector have a sense of quiet (and sometimes not so quiet) desperation. There is a strong urge to find some means -- almost any means whether effective or not -- of arresting the economic slide and to provide the additional capital so necessary to maintain current operations and permit much needed expansion of exploration and drilling activity.

One of the most frequently suggested solutions has been adoption of a tax/tariff or quota on imported crude oil and/or products.

IPAA recognizes the need for action but determined that the often conflicting economic, political and legislative ramifications of proposed solutions require careful analysis before embarking on a course of action which might have long-term negative consequences greater than any short-term benefits. The IPAA Executive Committee, therefore, appointed a Joint Task Force on Petroleum Imports to examine all relevant issues.

The task force has analyzed virtually all of the many arguments for and against petroleum import tariffs and/or quotas including the following:

- Increasing reliance on petroleum imports may lead to market instability due to unpredictable and volatile pricing policies of exporting nations.
- National security might be jeopardized by overdependence on unreliable sources of petroleum supply.
- Import tariffs can be a means to collect revenue to help reduce the federal budget deficit.
- Energy conservation may increase with higher petroleum prices that might result from import tariffs and/or quotas. Alternative fuel sources also could be developed further.
- The balance of payments deficit may be reduced through import tariffs and/or quotas.
- Current problems of energy lender banks would be alleviated.
- An import tariff could extend the lives of marginal oil and gas producing properties and increase domestic exploratory activity through higher prices.
- Restrictive import legislation would let exporting countries know that the U.S. will protect its energy industries from precipitously falling prices.
- Consumers would be protected from wide swings in the market and the resulting instability.
- Foreign petroleum producers appear to have competitive advantages over U.S. firms due to: (1) favorable tax treatment, (2) access to low-cost capital, and (3) fewer environmental restrictions. An import tariff could capture some of these economic advantages and, at a minimum, offset the costs incurred by the U.S. government in continuing its dependence on imported energy.

-- U.S. refiners have had to invest significant amounts of capital in meeting safety and environmental standards not required of foreign competitors. The EPA lead phase-down of gasoline and the pending Superfund bill are just two examples.

-- U.S. refinery operating capacity has declined and is likely to contract further with the profit margin squeeze resulting from: (1) the shift toward a lighter product mix, and (2) the influx of gasoline and blendstock imports at cut-rate prices.

-- The addition of new OPEC export refineries is expected to bring more refined product supplies to the American market, particularly in light of Japan's import barriers and the European tariff structure.

-- Domestic refiners are unable to compete with foreign suppliers because OPEC price guidelines apply only to crude oil, not refined products.

-- Net-back pricing systems enable foreign suppliers to sell refined products in America at prices lower than domestic refiners who pay market prices for crude oil inputs.

-- The strong U.S. dollar has combined with other key characteristics of the international oil market to effectively deny U.S. refiners access to product export markets.

-- Much of the so-called idle refinery capacity in the U.S. today is beyond the point of being returned to service due to high restart costs.

-- Loss of domestic refining capacity has driven down U.S. oil prices, consequently dampening petroleum exploration and production.

-- Recent refinery closings have been in areas where accessibility to crude oil is not a problem. Refineries shut down since 1983 include those that have invested in modern technology, not just facilities that existed as a result of the government entitlements program. Reduced operating margins exacerbated by the rising tide of petroleum product imports has been one of the primary reasons for this idle refinery capacity.

- Layoffs have been unrelated to wage rates because labor costs are not as great a factor in refining as they are in other more labor-intensive industries.
- Refinery closings have had a devastating impact on industry employment with multiplier effects throughout entire communities and the nation as a whole.
- Current laws pertaining to fair trade practices should be reviewed so that foreign refiners cannot dump their products in the U.S. market at prices below their fully allocated cost of production.
- U.S. agriculture must have uninterrupted access to equitably-priced supplies of petroleum fuels in order to assure dependable supplies of food for the nation and the world.
- Yet, agriculture is perhaps most vulnerable to energy disruptions since it is situated at the end of petroleum supply lines. Past import disruptions have been felt first and most acutely in rural farming areas where specific petroleum products are essential to agricultural operations.
- Petroleum import tariffs and/or quotas would end up costing farmers more for fertilizers, operating machinery, irrigation equipment, crop-drying, etc. The competitiveness of U.S. agricultural exports would suffer from an increase in both production and inland transportation costs.
- U.S. product quality and environmental specifications prevent refined products from being completely interchangeable among export refineries. Also relevant is the varying slate of products generated by different refineries.

- The U.S. must maintain sufficient domestic refining capacity to: (1) process maximum withdrawals from the Strategic Petroleum Reserve; (2) in time of emergency meet incremental military requirements over and above normal civilian uses, and (3) possibly supplement some of Europe's refined product requirements in a military emergency.
- Determining the minimum level of domestic refining capacity required to meet U.S. energy and national security needs will depend on several factors:
    (1) the security of long-haul sources of supplies as compared to imports from shorter distances in the 1970s such as the Caribbean,
    (2) the different product composition of imports (more light products and less residual fuel oil) and the capability for substitution with other domestic energy supplies,
    (3) the nature of ownership of the export refineries upon which America is dependent for product imports (private or foreign government) with the attendant risk of political factors outweighing economics in a military emergency, and
    (4) the likely capability of product importers to arrange for alternative supply sources in a crisis as effectively as the major oil companies did in the 1970s.
- There would be disproportionate regional hardships endured by: (1) homeowners in the Northeast and Midwest who use more heating oil than the national average, and (2) motorists of the Southwest who consume more gasoline.
- Energy-intensive industries such as aluminum and steel would be hurt at home and abroad due to increased energy costs.

- -- Demand for oil, which already is depressed, would be further dampened by resulting price increases. The domestic oil and gas industry might suffer an even worse shakeout than over the past few years.
- -- The overall level of product imports is well below historic levels. Even though gasoline and middle distillate imports are up, they do not pose a serious threat of penetrating the U.S. market.
- -- Imports of refined products are not a significant cause of the U.S. refining industry's dislocations. Current problems are a result of: (1) the uneconomic expansion of refining capacity in the 1970s, (2) the unresponsiveness of crude oil prices to declining product prices and (3) bad decisions regarding the mix of light and heavy crude supplies. Moreover, with the elimination of government price and allocation controls, refiners have had to struggle for market share in a period of declining demand.
- -- Refined product imports have always provided an important source of price competition for U.S. refiners, thus keeping prices lower for American consumers. By providing another source of supply for independent marketers who do not have upstream operations, product imports increase competition among domestic suppliers for the marketers' business.
- -- A substantial increase in the price of petroleum imports caused by import tariffs and/or quotas would raise not only the price of domestic petroleum products but also the price of all competing energy sources. Eventually the price level for all goods and services would be pushed upward, possibly causing economic growth to falter.
- -- Import tariffs and/or quotas may invite retaliation by other countries. More than half of our imports are presently coming from allies of the United States. In 1985, only four countries have provided 56% of our

petroleum imports: Mexico, 23%; Canada 14%; Venezuela, 10%; and United Kingdom, 9%.

-- New refining capacity in countries such as Saudi Arabia should not be considered as net additions because there have been significant offsetting reductions in operating capacity throughout Europe and Japan.

-- Petroleum imports should not be restricted or taxed on the basis of potential import levels. It is still not clear just how much additional refining capacity will be added in the Middle East and how much petroleum will be exported to the U.S. market.

-- An import tariff and/or quota may necessitate the creation of another regulatory bureaucracy and cause more competitive imbalances than it is designed to correct.

-- America's historical experience with oil import quotas set the stage for the price explosion of the 1970s.

-- If energy conservation is the goal of protective import legislation, there are more effective tools available to policymakers. Quotas and tariffs impose high costs and achieve little energy savings.

-- Import fees and energy taxes, in general, tend to be regressive. The financial burden falls most heavily on consumers who are least able to afford either the higher petroleum prices or conservation measures.

-- Consumers would be better served by maintaining an adequate and safe supply of crude oil available in the Strategic Petroleum Reserve.

-- Because an import tariff and/or quota would raise the cost of domestic as well as imported crude oil, U.S. petrochemical producers would be at a competitive disadvantage. With crude oil used not only as fuel but also as feedstocks, domestic petrochemical producers would eventually raise their output prices. Foreign competitors who have access to raw materials at below-market prices would be at an even greater comparative advantage.

- Petrochemical exports have always been a positive contributor to America's trade balance but it is likely that they would erode over time as a result of price increases caused by import tariffs and/or quotas.
- Imports of petrochemicals would also increase since foreign producers would be able to supply products cheaper than U.S. manufacturers, even taking the import duty into account. Ultimately, this would have a negative impact on America's balance of payments as well as employment.
- Purchasers of petrochemical products in the U.S. will find their costs higher to some extent whether the product comes from home or abroad. Such price effects gradually would filter through to companies manufacturing many diverse products from petrochemicals. Faced with the same problems as petrochemical firms themselves, makers of a range of goods from pharmaceuticals to plastics would raise their prices, setting off further ripple effects throughout the economy.
- U.S. petrochemical producers already face strong competition on the world market, particularly from major new export facilities coming on stream in Saudi Arabia and Kuwait. These new plants have significant competitive advantages relative to American firms over and above government subsidies that exist through natural resource pricing.
- Import tariffs and/or quotas would only worsen the relative position of U.S. petrochemical producers some of which already are hard hit with: (1) prohibitive import duties on feedstocks such as certain naphthas, and (2) Superfund tax legislation currently before Congress.
- Historical experiences with petroleum import tariffs and quotas indicate that they: (1) generate complex and inequitable governmental involvement

in the free market, (2) fail to prevent a growing U.S. dependence on foreign petroleum supplies, and (3) force capital investment in refining and petrochemical facilities to locations abroad, thereby reducing America's share of the world market.

These issues were examined not only in terms of short-run considerations but also the longer range implications.

In addition, a number of specific political issues were examined: (1) Would Congress pass an oil import fee? (2) Would the President sign a bill providing for an oil import fee? (3) Would Congress tax only foreign oil? (4) Even if Congress did not place an equivalent fee on domestic oil, would it in some other fashion claim all or a portion of the resulting increase in the price of domestic petroleum? (5) Would the imposition of an import fee only on foreign oil and products influence the outcome of current congressional deliberations regarding other tax provisions vital to domestic oil and gas producers? (6) Might the industry gain less from an "ideal" import tariff than it would lose on the tax front? (7) What would happen to revenues raised by an import tariff, i.e., would they be applied against the deficit or be offset by additional spending?

CONCLUSION

Our examination of these factors led to several critical but, we believe, inescapable conclusions. The economic effects of import fees are at best uncertain. It is impossible to predict that such an import fee would fulfill the objectives of Congress or the nation as a whole. Furthermore, even if some of the desired benefits were achieved they likely would be offset by unintended side effects which would create long-lasting difficulties for the petroleum industry, consumers and the general economy.

Substantial users of energy such as airlines, farmers, petrochemical manufacturers and others have rallied against such legislation. Representatives from "friendly" foreign suppliers of oil have already been heard against such legislation. Countries such as Mexico and Venezuela with serious debt problems oppose such legislation and seek exemptions from it. Special user groups from all parts of the country would also seek exemptions. A watered-down import fee would necessitate an even more complex administrative and bureaucratic mechanism than would a straightforward and simple import fee.

Even absent the above conclusions, this issue cannot be considered in a vacuum. The petroleum industry is in the middle of a fight for its life; the "tax reformers" are coming at producers from all directions. Once again, oil and gas producers are whipping boys for many politicians. Any action which would appear to benefit the industry in the short run would inflame those legislators desiring to change the tax treatment of the industry. It would be a poor trade-off if producers were to fight for an import fee whose effects were only temporarily beneficial, if at all, only to find that it had sounded the death knell for statutory depletion and expensing of IDCs by stimulating negative tax action by industry opponents. This is a foreseeable response to any action taken in favor of an import fee.

If our domestic petroleum industry is so economically threatened as to cause alarm for our national security and an import tax is not the answer, what can Congress and the federal government do? Several very important things. For example, let's first acknowledge that since the end of World War II, domestic oil and gas producers have never been permitted to operate in the free market. In addition to both direct and indirect controls on the wellhead price of oil and natural gas, producers have been staggered by an increasing array of complicated restrictions and controls on every aspect of their operations. Since 1969, producers have been subjected to no less than a half dozen major, and numerous other, negative tax changes which have denied producers significant portions of the increased revenues generated by relaxation of price controls. Even now, there are several additional punitive tax changes pending before the Senate Finance Committee which would compound the economic misery of this industry.

Specific positive steps which can and should be taken include the following:

(1) Adoption of a Marginal Well Production Maintenance Incentive to assure continuation, until the market stabilizes, of production from properties which would otherwise be abandoned.

(2) Restore percentage depletion for all domestic oil and gas production and repeal the 50% of net income and 65% of taxable income limitations and remove the restrictions on transfers of proven properties.

(3) Modify the definition of intangible drilling costs to include geological and geophysical costs and unrecoverable surface casing.

(4) Assure continued expensing of intangible drilling costs in the year expended or incurred.

(5) Eliminate restrictions on the use and transportation of natural gas.

(6) Remove natural gas wellhead price controls.

These are just the most urgent of an extensive list of positive changes Congress can make to help avoid the total collapse of the domestic petroleum exploration and production industry as we know it today. We will provide specific details of each of these and other suggestions when necessary.

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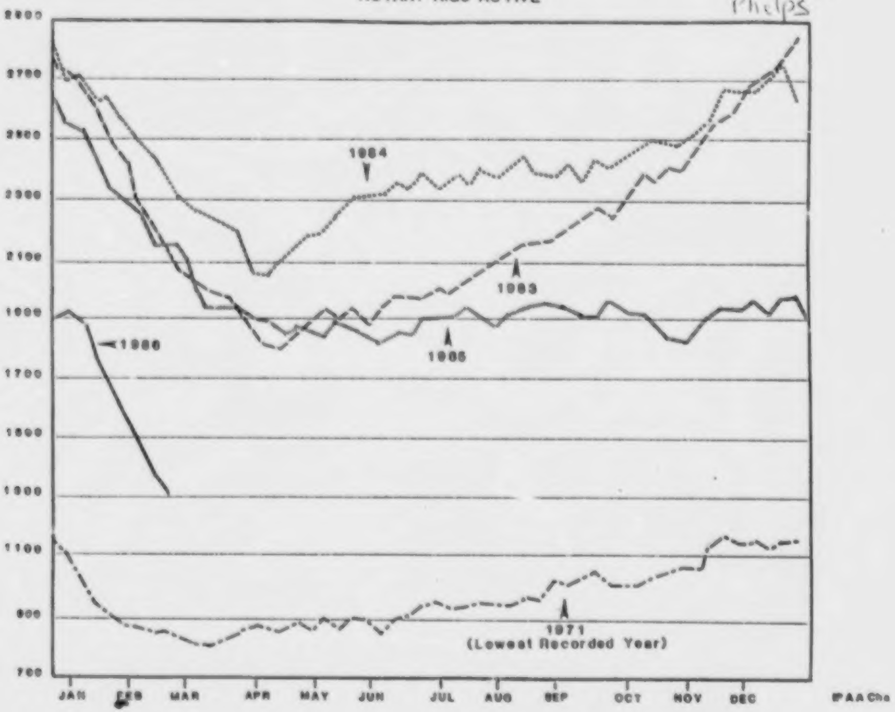
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STATEMENT OF JAMES W. HUNT, CHIEF EXECUTIVE OFFICER, SYNERGY CORP., AND CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, DALLAS, TX

Senator WALLOP. Mr. Hunt.

Mr. HUNT. Thank you, Mr. Chairman, Senator Bentsen.

My names is James W. Hunt. I am chairman and chief executive officer of Synergy Corp., which is a Dallas-based independent oil and gas company. I also am chairman of the National Energy Policy Committee of the Texas Independent Producers & Royalty Owners, a group that has about 5,500 members and a bunch of them are these one-armed witnesses that you needed, Senator.

I also would like to introduce my written statement into the record as well as the statement of Mickey Smith, president of the East Texas Producers & Royalty Owners Association.

Senator WALLOP. By all means. That will all be in their entirety.

[The prepared written statement of Mr. Hunt and the prepared written statement of Mr. Smith follow:]

TIPRO INFORMATION SERVICE

1910 InterFirst Tower Austin, Texas 78701 (512)477-4452

REMARKS BY JAMES W. HUNT

CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION

Mr. Chairman and distinguished members of the Committee, thank you for providing me with the opportunity to participate in this important hearing today. I am James W. Hunt, chairman and chief executive officer of Cenergy Corporation, an independent oil and gas exploration and production company in Dallas. Today, I am representing the Texas Independent Producers and Royalty Owners Association as chairman of TIPRO's National Energy Policy Committee.

Last summer, TIPRO adopted a "National Energy Security and Conservation Policy," which, among other things, calls for a fee on crude oil and petroleum products imported into the United States. As the largest state independent producer group in the nation, TIPRO has advocated its position as necessary to protect our nation's economic and strategic security by stabilizing falling domestic crude prices, with the favorable side effects of raising funds to reduce the federal deficit and providing relief for our troubled trade account.

You might wonder why TIPRO is assuming the political risks of encouraging Congress to adopt an oil import fee at the same time we are fighting against proposed changes in the current domestic tax treatment of intangible drilling costs and percentage depletion.

The answer to that question is simple: America needs a sound energy policy that encourages a strong domestic oil and gas industry in order to minimize the threat to our national security created by unacceptable levels of imported petroleum products from often unstable foreign governments.

We learned in 1973 during the Arab oil embargo that an energy crisis can create havoc for America's entire economy. In 1979 -- for the second time in less than a decade -- public concern was revived over how the U.S. economy could be controlled by foreigners. Our lives and our jobs were suddenly disrupted by questions of where we would obtain an adequate supply of energy to meet our nation's requirements for transportation fuel, electricity, and most importantly, a strong defense.

Today, America faces the prospects of rising imports, increasing consumer demand, and declining activity in domestic oil and gas exploration and production. We are once again facing a dangerous situation of overdependence on imports to supply our energy needs.

In the beginning, I was personally reluctant to accept the idea of an import fee on oil because of opponents' arguments that it could reduce the Gross National Product by increasing oil prices to American consumers and weaken the ability of energy-intensive U.S. industries to compete with their foreign counterparts. But as chairman of TIPRO's National Energy Policy Committee, I realized I had a responsibility to keep an open mind, consider all aspects of oil imports, and represent what would be best for the domestic oil and gas sector as a whole. Well, I learned something. When you drop your guard, abandon your defensive emotions, and witness what is going on in our industry, in the real world, you see things differently. You have to start by admitting that a discussion on an oil import fee should not be an academic exercise of debating economic theories. This is not theory, it's the real world.

If America was heading toward an overdependence on imported drinking water, all the economic arguments to the contrary would be completely thrown out. The federal government would take positive steps to assure an adequate domestic supply of water; otherwise the nation's people could die of thirst. It's easy to understand the consequences of doing otherwise because thirst is easy to understand. Well, I say that America is thirsty for an adequate supply of domestic oil.

In short, you, your colleagues in the House and Senate, and the President -- as elected caretakers of our nation -- are currently faced with an important question: Shouldn't a stable supply of domestically produced oil and gas be the foundation for satisfying our nation's vital and fundamental need for energy? The answer to that question is, without doubt, yes.

I am not talking about a goal of energy independence, but the need for a national energy policy. The United States is going to import some portion of its oil needs for the foreseeable future. But should this amount increase just because certain nations are currently dumping crude oil onto the world market, causing the price to fall so quickly that the domestic industry has no economic choice but to stop important drilling programs?

Current events dramatically underline the fact that this is not mere speculation. Posted crude prices in the United States are rapidly dropping to the $15 per barrel level. Responsible independent operators have advised TIPRO that operating costs for most stripper wells in the nation's mid-continent area slightly exceed $15 per barrel. Should prices dip below that level for just a few months, there will be a massive shut-in of domestic producing wells.

Stripper wells provide approximately 15 percent of the nation's total daily crude production. Other high cost production includes Alaskan North Slope oil, which is another 15 percent of the national total and California heavy crude oil, which is approximately ten percent of the total. Should all three of these sources dry up, imports would have to double virtually overnight to meet America's energy needs. The consequent problems arising from such a supply shift would be severe. No longer would it make sense to express euphoria in the nation's media over the "benefits" of sharply declining petroleum prices.

Unfortunately, there are those who forget about energy security when gasoline prices are falling at the pump, despite the fact that price declines at the service station represent only a small percentage of the rapid drop in oil prices at the wellhead. Most of our domestic rigs are already stacked. If America does not wake up to this danger, we will be back at the import dependance level that endangered our nation's economic and strategic security in the 1970's. Without domestic exploration and production, we will once again be giving foreign nations a powerful weapon that will make us vulnerable to political blackmail, which at the very least could mean exorbitant energy prices in the future. Finally, everyone would understand, admittedly the hard way, that the best long range interest of American energy consumers requires a secure, economically developed core supply of domestic production.

The situation reminds me of the old movie theme that portrays the man selling his soul to the devil for an immediate pleasure. When the devil comes to collect, the sinner regrets having taken the easy way out. Well, you could say that America runs the risk of doing just that if we continue to look beyond the real price of imported oil. Shall we sell our souls to OPEC just to get cheaper oil prices today? The devil always comes back to collect his dues. Let's not allow Hollywood the chance to make a documentary film on us making that mistake. Casting could have a ball picking the characters in that one!

The federal government took steps in the 1970's to protect America from being vulnerable to foreign oil producers. To insure that accessible, affordable energy would be provided in the future to all segments of our society, federal programs were put into place for development of synthetic fuels, a strategic petroleum reserve and protection of shipping lanes. American taxpayers have paid ever since and continue to pay the costs of "protecting" imported oil supply through these programs.

In effect, Americans have paid more for so-called "cheap" foreign crude than for domestically produced oil by:

* Filling and maintaining the Strategic Petroleum Reserve at the cost of more than $15 billion, with interest alone on this expense totalling approximately $1.5 billion per year, or almost one dollar per barrel of imported oil;

* Expending more than $57 million in [illegible]inistrative expenses alone for the Synthetic Fuels Corporation, with further [illegible]sible outlays expected when shortages in conventional fuels reoccur;

* Paying as much as $50 billion a year, according to some Congressional sources, to protect the shipping lanes in order to maintain oil import flow to the United States.

A policy that requires foreign producers to pay a portion of these "hidden costs" of oil imported into the United States will lessen the burden on American taxpayers by reducing the federal budget costs for import protection and providing incentives to develop domestic reserves. Furthermore, since approximately 50 percent of our trade deficit is due to oil imports, increasing domestic production would reduce the huge annual outflow of dollars from the United States.

We learned in the 1970's what an extreme rise in the price of oil could do to American jobs and economic output. An extreme drop in the price of oil can have similar severe consequences. In short, rapid changes in oil prices generate dangerous economic strains regardless of the direction. If we risk dismantling our nation's oil and natural gas industry because foreign oil supplies currently seem cheaper, the U.S. could become nearly a 100 percent importer of crude oil and our nation could truly become hostage to the political uncertainties of nations in the Middle East and North Africa, which control the surplus supply of petroleum.

Consider these facts:

* OPEC nations control most of the world's proven oil reserves and 95% of the world's unused oil production capacity, and their production costs are significantly lower than ours;

* It's not uncommon for a Saudi Arabian well to produce 36,000 barrels per day, while an average U.S. oil well produces less than 15 barrels per day;

* Countries that import oil into the United States do not support federal, state, and local government programs by paying state taxes, production taxes, severance taxes or windfall profit taxes. The domestic industry has paid more than $77 billion in windfall profits taxes alone since 1980. Imports have paid none.

An oil import fee should be a temporary measure that can be used to counter the "dumping" of cheap foreign oil on the world market by countries who control the surplus supply and are currently participating in a strategy to increase production in an effort to discipline other oil exporting nations.

Such a tariff system would not be a windfall for independent domestic producers, but a measure designed to keep them alive and competitive in a world market by capturing for domestic purposes some of the economic rent -- the difference between selling price and production costs -- now going to oil exporting countries and shifting to foreign producers part of the cost burden of maintaining import flow into the United States.

Domestic reserves must be maintained to avert embargo risks. Both domestic producers and consumers should be protected from the extreme fluctuations in the world oil market created by the whims of nations who would undermine our goal of ensuring a consistent supply of adequate and affordable energy.

In the 1970's, in order to protect consumers from the shock of huge price increases and to keep the domestic industry from becoming too profitable, Congress imposed the windfall profits tax on domestic producers. Now we need the reverse of the windfall profits tax; we need to protect consumers from the consequences of severe price declines. Congress must determine a stabilizing price level for crude oil that will allow producers to maintain a domestic petroleum industry capable of minimizing reliance on foreign oil. So long as the exporting countries' incremental producing costs do not exceed the U.S. benchmark price less the import fee, competition will lead the exporting countries to absorb at least a portion of the fee, leaving the world price (the price outside the U.S.) substantially lower than it would have been without the fee. Such an outcome would be favorable to the U.S. economy as a whole. Foreign producers would be paying a tax to the U.S., at little or no added expense to U.S. consumers.

The best guarantee against "hijack" prices in the future is to keep the infrastructure of the industry diversified so that independent producers and the service industry can survive. If domestic exploration and production collapses, we may well see only a few international oil companies -- many of them owned by foreign governments who have no regard for the American consumer -- controlling the price and supply of oil.

Just as overdependence on imports adversely affects our nation's consumers and producers, other important factors of our economy also suffer. For example, in Texas, economists at Southern Methodist University have predicted in a study recently released by our own Senator Lloyd Bentsen that Texans could lose 250,000 jobs and $30 billion in purchasing power over the next three to five years if oil prices settle at $15 per barrel. The primary victims will be small businesses, Texas banks, and blue and white-collar employees.

Having discussed the economic reasons for needing a secure domestic oil and gas industry, I would now like to move briefly to the strategic reasons why we need a stable domestic industry. Simply, the domestic oil and gas industry is a defense industry, and is vital to the survival of our nation. The Department of Defense is the nation's largest consumer of petroleum, even in peace time, and use is projected to quadruple in the event of war.

Tanks, airplanes and ships require petroleum to operate. Currently, U.S. planes, ships and land vehicles consume more fuel than they did in 1975 when concern was expressed about supply interruptions. What is the sense in advocating an annual $260 billion plus defense budget, if we don't have a secure supply of energy to operate our strategic machinery?

Now I realize that we've got plenty of oil for the military to run a war -- the military will get their oil. So, America's military security is not in danger. But where will the Defense Department get its oil in time of shortages? Like a 900 pound gorilla, anywhere it wants to -- from you, me, airlines, manufacturers, etc. And that's how America's economic security is affected. The economy is a factor in national security, too -- just like defense. Our defense needs will be satisfied in times of oil shortages by robbing the economy.

The President and Congress have set a precedent for protecting national security through certain policies. For example, President Reagan and the Congress have agreed that the United States will not allow critical military equipment, such as naval vessels, to be contructed in foreign countries (10 U.S.C. 7309).

I notice no one has suggested we disband the Army, Navy, Air Force and Marines and rely on the free market to supply mercenaries at the cheapest available price to defend our shores. Think of the money that would save -- we could eliminate the budget deficit by liquidating the Department of Defense. But that's ridiculous. We all realize we must pay for preparedness. Well, I say it is just as important to our national security to have a secure supply of domestic petroleum to operate our military equipment and fuel our economy.

The Soviet Union, a leader in world oil production, is not dependent on imports. The petroleum balance, frequently overlooked in discussions of the strategic balance between the United States and the Soviet Union, has tilted toward the USSR because of its self-sufficiency and export leverage. Further, by increasing oil imports, the United States could very well strain relations with less richly endowed allies who resent the United States' unwillingness to fully develop domestic energy resources and doubt America's ability to honor commitments in an oil crisis.

TIPRO believes that a sound national energy policy requires that an import fee on crude oil and petroleum products be adopted, in addition to the retention of existing incentives for oil and gas well drilling in the United States. This is planning ahead for the military and economic security of America and the free world.

Americans have had it so good for so long in this country that many of us think God guaranteed all this energy to us forever at cheaper than replacement costs. That's just not so. The U.S drilling rig count continues its precipitous decline. With oil prices weakening further, Hughes Tool Company counted 1376 active rigs in the United States last week, off 37 percent from a year earlier.

That total is the lowest in more than a decade and is predicted to drop even further.

We independent producers have had the responsibility of discovering almost 90 percent of the oil and gas produced in this country. Some of us are now accepting the responsibility of informing our nation about the dangers of increased reliance on petroleum imports, not only for the sake of our own industry, but most importantly for the well-being of all Americans.

I thank you for the opportunity to tell our story today, and appreciate the support that you, Mr. Chairman, and many of the members of your Committee have given us on this issue. I would be happy at this time to answer any questions that you might have regarding TIPRO's position on an oil import fee.

STATEMENT

TO THE

UNITED STATES SENATE

NINETY-NINTH CONGRESS

COMMITTEE ON FINANCE

HEARING ON OIL IMPORT TAX

BY

MICKEY D. SMITH

PRESIDENT

EAST TEXAS PRODUCERS & ROYALTY OWNERS ASSOCIATION

P. O. BOX 10090

LONGVIEW, TEXAS 75608

FEBRUARY 27, 1986

Mr. Chairman:

Members of the Committee:

My name is Mickey D. Smith. I am President of East Texas Producers & Royalty Owners Association, a non-profit oil and gas industry trade association covering 76 counties in East Texas, based in Longview, Texas. Our membership consists of independent oil and gas producers, individual royalty owners, service-related companies and other businesses who are dependent on the stability of oil and gas production and marketing for their economic well-being. Like you, I share a growing concern for our nation's economic well-being and national security. I am a businessman, and it is my privilege to serve as Mayor of the City of Kilgore, Texas.

I join with many of the distinguished members of Congress in urging support of a tariff on imported oil. At a time when our federal deficit must be cut $55 Billion, a $5 a barrel tariff on foreign oil would bring in about $18 Billion each biennium. As noted in an editorial appearing in the New York Times on December 24, 1985: "An import fee offers additional benefits. Most taxes, even if necessary for revenue, are wasteful because they drive a wedge between real costs and prices, discouraging effort and reducing demand. But an oil import fee would actually improve efficiency, forcing consumers to absorb the hidden costs of dependence on unstable foreign supplies." In 1984 energy imports accounted for 45.3% of the nation's entire total trade deficit.

Currently, the five million barrels of crude oil entering this country every day is taxed at a scant 50 cents a barrel and refined products at less than two cents a gallon -- far from equal to the levies on domestic products.

Imported oil and imported refined oil products have brought the domestic oil industry literally to its knees. Over the past three years, more than 130 U. S. refineries have closed, most driven out of business by OPEC refineries with access to cheap, subsidized oil.

The economy in Southeast Texas, the Houston/Beaumont area, is in shambles because of refinery closings in that area. A study by Lamar University found that more than 54,000 manufacturing jobs, all related to petroleum, have been wiped out over the last five years on the Texas Gulf Coast alone.

The argument that an import fee hike would move the U. S. into protectionism can be discounted. Each of you is well aware of the fact that essentially all of the foreign oil entering our country is produced and sold through government-sponsored cartels. Cartels are expressly prohibited by law in our nation. We are decidedly at a competitive disadvantage. There has been no order in the marketplace since OPEC imposed its embargo in 1973. For the past 12 years, the world has suffered from an artificial price structure set up by OPEC, and now is the time to turn the table.

Let me point out that the import tax would increase demand for domestic oil, creating jobs and revenue. For our national security, new oil reserves are critical. You may or may not be aware that East Texas produced 85% of the oil necessary for the Allied War effort during World War II. Our own Interior Secretary, Donald Hodel, made the following statement several months back in the U. S. News and World Report:

America will have to find 32 billion barrels of new oil reserves during the next 10 years just to keep domestic production at current levels. If exploration and discovery continue merely at current rates, domestic production will decline by almost 2% annually through the rest of this century."

Do not be deceived into believing that you are preserving a national resource of oil by curtailing its production. If the independent producer is forced to the wall by further curtailed production and reduced revenues, additional wells must be abandoned. According to the National Stripper Well Survey compiled by the Interstate Oil Compact Commission, 14,000 stripper wells -- those capable of producing 10 barrels of oil per day or less -- were abandoned in the year 1984. In that year, stripper wells produced 463,459,000 barrels of oil and accounted for approximately 15% of the nation's total oil production and about 70% of the total number of U. S. oilwells.

"Every barrel of oil resulting from a longer life of stripper wells means the United States will reduce its dependence on overseas imports by a similar amount." said R. Harlan Krumme, President of the National Stripper Well Association. We cannot jeopardize our national security and our national economy by forcing abandonment of these wells because of the glut of foreign oil produced by cartels.

I respectfully submit that the time for action is now. Our nation needs the tax revenues. Our oil-related industries need an incentive to discover the required domestic oil reserves and create jobs and revenues. And our national security requires the discovery and continuation of our nation's oil and gas reserves.

Mr. Hunt. Last summer, TIPRO adopted a national energy security and conservation policy which calls for, among other things, a fee on crude oil and petroleum products imported into the United States. We were not motivated by a revenue purpose, but for national security purposes, the military and economic security of America.

Well, I have been ridiculed, brow-beaten, cajoled, called a simpleton and everything for citing national security and national defense as an argument. I have been asked that didn't I realize the military would get all the fuel it needed to wage and conduct a war. Well, I do realize that, but where will it get it? Like the 900-pound gorilla, it will get it from any place it wants to—from the domestic airlines, from this economy—and we will reek the same kind of havoc we did in the 1970's.

In 1973, the Arab oil embargo showed us how the American economy could be controlled by foreigners. So the Government took steps to protect us from being vulnerable again. Federal programs were put into place, the Synfuels Corp., the strategic petroleum reserve, military protection of shipping lanes. U.S. taxpayers began paying a tax to pay the cost of protecting imported oil through these programs. In fact, billions of dollars of tax, and the payment still goes on.

When oil prices began rising, Congress passed the windfall profits tax to protect consumers from the shock of rising oil prices and to keep the domestic producers from profiting from the windfall. U.S. industry has paid $77 billion in windfall profit tax since 1980. Foreign producers have paid none. It is time they do.

We need the reverse of a windfall profit tax mentality to protect consumers from the shock of price decline. Otherwise, we face dismantling the U.S. oil and gas industry, the independents and the service companies, and becoming 100 percent dependent on imports. The result—$100 OPEC oil in the future perhaps.

This is pretty simple logic to me. I watched the President last night. I read the papers. I know that during a Senator's single term of 6 years this Nation will go along with over $1½ trillion of defense spending. We recognize that we must pay for preparedness, to be ready. In order to avert war, we have got to be prepared to do so in order to gain the right to have peace.

President Reagan last night pleaded with us to understand the need to be prepared for war in order to preserve peace. And he quoted George Washington.

Well, the President and the Congress have set precedents in a law passed in President Reagan's first term that prevented the construction of naval vessels in foreign yards. Certain strategic things are just not left up to the free market. The President spoke of Russia's superiority. They are certainly not dependent on foreign oil or imports.

We simply cannot rely on the market place especially in matters of strategic importance. I wonder if the economists feel that it makes sense if we had zero U.S. production. I doubt that. So somewhere between zero and where we are today, something must be done.

And so what? We need an oil import fee to show the world our resolve to assure some minimum level of U.S. production to go along with our huge defense spending; not to raise revenues necessarily, but to help provide stability for the economic security of America, like the Wallop-Bentsen bill—a temporary, variable fee tied to a floor price with no exceptions. We will overcome the bureaucracy concerns that way.

It is hard for me to imagine how consumers are suffering even at a $22 oil price having been subjected to $38 oil. That is a 42-percent decrease in oil prices.

I endorse Mr. Singer's earlier suggestions as an economist who at least recognized the difference between oil as a commodity and manufactured goods. The other economists seemed to be caught up in the euphoria of lower oil prices, which sort of reminds me of the movie about the man who sells his soul to the devil. In the end when the devil comes back, he regrets that he has done that.

Mr. Hall, also an economist who spoke earlier, talked about conditions in the Texas oil industry. It is quite apparent to me he is not an expert on that. He quoted $20 posted prices. I sell it everyday between $14 and $16.

May I go on, Mr. Chairman?

Senator **WALLOP**. Yes.

Mr. **HUNT**. Perhaps it would be easier if we thought about drinking water. If we had an unreliable or unhealthy dependence on imported drinking water, despite all the economists' arguments to the contrary, Congress would do something about it because it is easy to understand thirst. Well, I think this oil import fee would reduce our ability—as the economists say—to compete with foreign manufacturers. Well, so does labor, but no one is suggesting that we lower our standards of living and break up the labor unions and do things of that nature that would reduce labor costs so manufacturers can compete with foreign manufacturers better.

I would like to close by just mentioning a couple of ratios we use in our business. The risk reward ratio you know about. The aggravation reward ratio is one we have and that is what is causing independents to leave the business.

The risk reward ratio is worthy of mention because if we risk our national security for the rewards, these temporary rewards, of artificially low oil prices and we are wrong about it, it could be fatal to America and the free world.

Thank you.

Senator **WALLOP**. Thank you, Mr. Hunt.

Mr. Jandacek.

STATEMENT OF GEORGE JANDACEK, VICE CHAIRMAN, CROWN CENTRAL PETROLEUM, BALTIMORE, MD, ON BEHALF OF THE INDEPENDENT REFINERS COALITION, AND THE AMERICAN INDEPENDENT REFINERS ASSOCIATION

Mr. **JANDACEK**. Thank you, Mr. Chairman.

I appear here today in my capacity as chairman of the Independent Refiners Coalition. However, I am offering testimony on behalf of both the IRC and the American Independent Refiners Association. An emergency prevented Mr. James Lopeman, the Trade Association president from testifying. However, Mr. Ray Brag, the association executive director, and I will be glad to respond to any questions you may wish to ask regarding our testimony.

Our coalition represents one-half of the independent refining capacity in the United States. We appreciate this opportunity to present our views on the proposed imposition of an oil and refined product import fee.

The decision to impose a fee will ultimately be based on the political and economic judgment of Congress and the administration. While at this time we take no position for or against import fee legislation in general, we have, for the purposes of this testimony, assumed that a fee will be levied. On that basis, we will discuss the impact of S. 1997 and S. 1507 on the domestic refining industry.

It is to the credit of Senators Wallop, Boren, and Bentsen that their bills recognized the need for a higher fee on product imports than on crude oil imports. The U.S. refiner operating costs will automatically increase due to a crude oil import fee which simply adds to the environmental cost of U.S. operations which are already greater than those of our foreign competitors.

U.S. refiners use about 10 percent of the energy in a barrel of crude oil to convert it into products. Thus, operating costs will rise by 10 percent of the import fee on crude oil. Working capital costs and inventories required to operate the refinery will increase by about 1 percent. Therefore, based on these calculations, the product import fee should be approximately 111 percent of the crude oil import fee to avoid legislating an automatic operating cost disadvantage for U.S. refiners.

Our written statement also quantifies the U.S. environmental and lead phase-down cost advantages available to foreign refiners. Since 1980, the U.S. refining industry has paid an average of $2½ billion a year in air and water pollution control costs. In addition, the slow pace of lead phase down in other nations provides their refiners with a significant cost advantage to export gasoline to the United States.

To offset these inequalities, we calculate that the product import should pay an additional $2.30 a barrel in environmental offsets. Thus, the total fee on imported products should be approximately 111 percent from the crude oil fee plus about $2.30 to offset environmental disparities.

We cannot recommend any exemptions from import fees for specific foreign oil producers or for specific product imports. The exemption of specific product imports, such as home heating oil, would increase imports of that product and produce massive, unavoidable losses for U.S. refiners.

In addition, this foreign cost advantage would not be passed through to U.S. consumers of heating oil. The foreign refiners would simply set their prices just low enough to out compete the higher cost U.S. products and pocket the difference. If exemptions are necessary, the fee should be charged at the border and then rebated to final users. This rebate would give more of the savings to consumers than would the exemption. This approach is similar to that proposed in S. 1507.

If any product imports are exempted from the fee, the fee on nonexempted products must increase proportionately as detailed in the table on page 12 of our written statement. To remain competitive in world markets, no U.S. petroleum exports should bear any cost of an import fee.

Now we recognize that other methods could be used to calculate the differential on product imports. We have identified only the most obvious factors that must be offset in import fee legislation. We have taken what we believe is the simplest and least disruptive approach to calculating an import fee. The level of the higher product differential identified in our testimony is only one approach. It is not the only answer, but it is the best first answer we can give the committee today.

We would appreciate the opportunity to work with the committee to develop appropriate levels of product fees.

The longer term survival of the U.S. refining industry is dependent on the basic energy and tax policy adopted by the Congress, but our immediate economic survival is dependent on not being placed at a further competitive disadvantage with foreign refiners by your actions on this issue.

From an energy policy standpoint, we wish to emphasize that the proposed import fee legislation will not offset unfair trading practices of foreign competitors, nor will it diminish the threat to national security by increasing imports of gasoline and other refined products.

Our testimony today addresses only additional problems in cost inherent in an oil import fee and environmental legislation already in place.

Mr. Brag and I would be pleased to answer your questions at the appropriate time.

Senator WALLOP. Thank you, Mr. Jandacek.

[The prepared written statement of Mr. Jandacek follows:]

STATEMENT OF GEORGE JANDACEK
CHAIRMAN OF THE INDEPENDENT REFINERS COALITION
AND JAMES H. LOPEMAN
PRESIDENT OF THE AMERICAN INDEPENDENT REFINERS ASSOCIATION
CONCERNING S. 1997 and S. 1507
BEFORE THE ENERGY SUBCOMMITTEE
OF THE SENATE FINANCE COMMITTEE
UNITED STATES SENATE

February 27, 1986

Mr. Chairman and Members of the Subcommittee:

I am George Jandacek, Vice-chairman of Crown Central Petroleum Corporation of Baltimore, Maryland. I appear here today in my capacity as Chairman of the Independent Refiners Coalition, which represents 34 independent refining companies, including the American Independent Refiners Association (AIRA), a trade association. With me today is James H. Lopeman, President of MacMillan Ring-Free Oil Company, Inc. Mr. Lopeman appears in his capacity as President of the American Independent Refiners Association. Our coalition represents over two million barrels a day of U.S. refining capacity.

We appreciate this opportunity to present our views on the imposition of an oil import fee on petroleum and petroleum products. We specifically address S. 1997, introduced by Senators Wallop and Bentsen, and S. 1507, introduced by Senators Boren and Bentsen. Beyond a brief discussion of the larger effects of the proposals, our testimony concentrates on the impact of the proposed legislation on the U.S. refining industry.

The decision on a crude oil and product import fee is a political and economic judgement for the Congress and the Administration. It affects energy policy, national security, tax and budget policy. At this time, we take no position for or against import fee legislation in general. For purposes of our testimony at this hearing, we have assumed that an import fee will be adopted.

Our testimony is directed at the need for a higher fee on imported refined products. We want to state the obvious at the outset, however. An import fee on crude oil alone, or exempting some products like home heating oil from any fee at all, would be devastating to the domestic refining industry.

The importance of domestic energy industries to the overall economic, energy and national security considerations of the United States is beyond dispute. We commend the Senators who are grappling with the difficult task of limiting the adverse effects upon these industries caused by the chaotic world oil situation. While lower energy prices can be a boon, the failure to recognize that they also have serious consequences for millions of Americans and for a major portion of our economy could, in the future, turn the boom into a bust.

The sponsors of the legislation we will discuss today are acutely aware of the problems which are arising as energy prices decline. Very few people will dispute the positive effects of the decline. But many people apparently do not understand, or do not remember, that greater U.S. energy independence since the 1970s has been achieved at a very high price, and that the erosion of that greater independence will also bear a very high price. Imposing a fee on petroleum imports will allow the U.S. Government to receive some benefit from the declining prices, while cushioning the impact of the price decline on our ability to produce energy.

The bills being considered today each share an important realization: that, in order to prevent major damage to the domestic refining industry, it is essential that a higher fee be imposed on refined petroleum product imports than on the crude oil used to make them. Our purpose here is to clarify the need for this higher product differential, and to provide our analysis of what that differential should be. Our testimony will describe and quantify the distinct elements which should comprise the higher differential on imports of refined products.

At the outset, we realize that political pressures could exempt some oil imports or refined products from the import fee. We urge you not to grant any exemptions. Exemptions for crude oil or other feedstocks will undermine the revenue aspects of the legislation and open the floodgates for special treatment on a country-by-country basis. Product exemptions will result in market distortions, increase imports of exempted products and diminish U.S. production of the exempted products. The ultimate purchasers of exempted products will become increasingly dependent on foreign sources. Overall dependence on imports will increase. Exemptions will also diminish revenues from the fee. If exemptions are inevitable, the fee should still be collected at the border and rebated as needed. An import fee could make U.S. petroleum product exports non-competitive in world markets. Therefore, it is critical that those product exports do not carry any of the economic costs of an import fee. A rebate should be granted for exports of petroleum and petroleum products.

We have identified three areas where the proposals need fine-tuning to achieve their intended result:

- **Operating Costs -- the proposals, in current form, will increase U.S. refinery operating costs in relation to those of other world refiners;**
- **Environmental Offsets -- under certain conditions, the proposals will not offset the environmental cost disadvantage borne by U.S. refiners which is not borne by our foreign competitors; and**
- **Exemptions -- exempting specific products or specific foreign oil producers from the fee will result in market distortion and diminish U.S. production of the exempted products. In addition to causing an**

increase in imports of those products, such exemptions would be a U.S. Government grant of an unfair production cost advantage to foreign refiners. Any exemptions will require higher fees to be imposed on unexempted products to prevent a legislated economic loss for U.S. refiners. Finally, exemptions will reduce revenues generated by the bills.

Our testimony offers solutions to these considerations, which easily could be incorporated in the bills. These considerations are critical to the survival of U.S. refiners. We have testified previously that U.S. refiners are plagued by unfairly-traded imports from government-owned and supplied refineries overseas. Increasing imports of gasoline and other refined products have resulted in the shutdown of U.S. refineries since 1983. Diversion of product exports due to tariff and non-tariff barriers existing in the other major consuming nations continue to exert intense pressure on refiners operating in the U.S. market. According to data published in the 1984 British Petroleum Statistical Review of World Energy, the U.S. refining self-sufficiency ratio is now the lowest of any world region (Chart A). Additional cost disadvantages caused by improperly designed import fees will result in further shutdowns and increased dependence on refined product imports.

OIL PRICE DECLINE THREATENS INDEPENDENT OIL PRODUCTION

From an energy policy standpoint, the sudden price decline is problematic -- in some respects it is dangerous. The fall in world crude oil prices will certainly cause a more precipitous decline in domestic exploration and production. Most immediately threatened is the production of approximately one million barrels a day of oil from stripper wells. Much of this production is supplied by independent producers, who supply the bulk of independent refiners' domestic crude oil supplies. The viability of these independent producers is critical to the operations of independent refiners nationwide.

The immediate effect of reduced domestic crude supplies will be greater dependence on oil imports to replace lost domestic production. As demand increases in the future while domestic production continues to slide, it is highly probable that more and more of the petroleum imports will be in the form of refined products; this will shut down more U.S. refineries and create a greater national security problem than the increase in crude oil imports.

IMPACT OF THE PROPOSED LEGISLATION ON U.S. REFINERS

If an import fee is adopted by the Congress, such legislation should reflect a higher differential for refined products. If the differential is not included, foreign refiners will automatically be granted a major production cost advantage. If certain refined products are excluded, U.S. refinery economics will be disrupted, resulting in further U.S. refinery shutdowns. The independent refining sector will be most severely affected.

Whether import fee legislation is finally adopted or not, the Congress should correct the environmental cost inequities which result from environmental costs levied on U.S. refiners but not on foreign refiners.

Mr. Chairman, we also feel obligated to comment on another much-discussed version of an energy tax -- a new excise tax on gasoline. As in the case of an import fee, there is equal concern within the industry about the ramifications of a gasoline excise tax. Therefore, we feel that any gasoline excise tax proposal should be given the same careful scrutiny that you are giving the oil import fee proposals. For example, refiners of gasoline fear this tax could also levy a severe burden on the domestic refining industry, by causing us to contend with unfair foreign competition for a share of a U.S. market which would shrink due to the tax. This implies, and experience at the State level bears out, that market forces could hinder the tax pass-through. If this happened, it would cause our industry to absorb some part of an excise tax of the type and magnitude under discussion. However, there are differing opinions about a gasoline excise tax within the refining industry.

The following portion of our testimony is technical, so we need to define some terms. The terms "crude oil" and "feedstock" are used interchangably. They refer to petroleum that is purchased for further processing such as cracking, distillation or reforming. "Products" and "blendstocks" are petroleum that is purchased for direct consumer uses and simple blending into consumer products.

For subsequent discussion purposes, based on the current $15 per barrel spot price of crude oil, the oil import fee in S. 1997 would be about $7 per barrel. The fee in S. 1507 would be about $5 per barrel.

Operating Costs for U.S. Refiners Will Increase

1. Fuel Costs

> **U.S. refiners use energy equivalent to 10 percent of their crude oil to convert crude oil to refined products. Of this 10 percent, about two-thirds derives directly from crude oil. A fee which increases crude oil prices to U.S. refiners would increase U.S. production costs relative to foreign costs.**

In 1984, U.S. refiners used 2.67 quadrillion BTUs to convert 12 million barrels per day of crude oil to refined products (Chart B). According to the BNA Energy Report (10-24-85), U.S. refiners have increased energy efficiency by 27 percent since 1972. However, they still need approximately 10 percent of the energy content of crude oil to convert crude oil into refined products. Two-thirds of this energy is derived directly from the crude oil itself. The cost of other fuel sources, natural gas, coal and electricity, will respond directionally to the imposition of the crude oil import fee.

A $7 per-barrel fee on crude oil would increase U.S. refinery fuel costs by $.70 per barrel. A $5 per barrel fee would increase refinery fuel costs by $.50 per barrel. This translates directly into a production cost advantage for foreign refiners who do not pay such a feedstock fee. To offset this competitive advantage, fees on imported products need to be 110 percent of the fee on crude oil.

2. U.S. Refiners' Working Capital Costs Will Be Increased

Paying above-world oil prices increases the cost of inventory, raising working capital requirements and interest payments for U.S. refiners, again leaving foreign refiners unaffected.

Despite incentives to reduce inventories, such as high interest rates and falling oil prices, U.S. refiners have carried on-site inventories equal to about 35 times their average refining runs since 1981 (Chart C). The inability to reduce this stock level indicates that the minimum on-site inventory requirement is 35 barrels for every barrel which is refined.

To carry adequate inventories, nearly all refiners must borrow money. Major integrated oil companies probably pay prime rate. Independent refiners typically pay prime plus one or two points. Thus, a $7 import fee would cause a U.S. refinery to need $245 more working capital for every barrel of oil it refines. Assuming a 10 percent interest rate, working capital charges would increase by about 7 cents per barrel. A $5 per-barrel import fee would cause a U.S. refinery to need $175 more working capital for every barrel refined. At a 10 percent interest rate, working capital charges would increase by about 5 cents per barrel. Foreign refiners would not bear this cost. To offset this U.S. disadvantage, Congress must tax imported products about 1 percent more than imported crude oil.

Existing Environmental Cost Disparities Disadvantage U.S. Refiners

3. Air and Water Pollution Control Expenditures

> **U.S. refiners have paid $2.5 billion annually in air and water pollution control costs since 1980. Foreign refiners exporting to our market do not bear these costs. This inequity must be corrected.**

According to the American Petroleum Institute, environmental conservation expenditures by the U.S. refining industry have averaged $2.5 billion annually since 1980 (Chart D). This amounts to about $.57 per barrel of crude oil processed, or 2.5 cents per gallon of gasoline produced. This cost is independent of the fee level. A March, 1985, Congressional Budget Office (CBO) study, "Environmental Regulation and Economic Efficiency," showed that other countries were not only spending fewer absolute dollars on pollution control than the U.S., but that they were spending a lower percentage of their Gross Domestic Product (Chart E). While the data on environmental expenditures is quite spotty in the CBO report, it leads to the conclusion that the cost of meeting U.S. environmental regulations puts U.S. refiners at a competitive disadvantage. To offset this handicap, product taxes need to be $.57 per barrel more than crude oil feedstock taxes.

4. U.S. Lead Phasedown Costs Create Competitive Disadvantage

New U.S. expenditures to meet EPA's U.S. lead phase-down requirements have provided a major production cost advantage to foreign refiners that do not have to limit lead use.

EPA has quickened the pace of lead phasedown in the United States. EPA's estimate of the cost of reducing lead use in gasoline from 1.1 grams per gallon to .1 grams per gallon is $2 billion per year in addition to the $2.5 billion in air and water pollution costs. However, this does not represent the full competitive disadvantage created by unilateral lead phasedown.

There is a popular misconception that gasoline is produced as a single product, and that if it meets U.S. specifications on octane and lead useage, then it must have similar production costs. This is not true. Refiners worldwide produce gasoline as components, which are blended to meet customer specifications. This universal production procedure enables foreign refiners to use lower-cost, lead-derived octanes in the gasoline they consume domestically and free up higher octane components and unleaded gasoline for the U.S. market, where octane costs are much higher. With the exception of Japan, all countries allow more lead use than the United States (Chart F).

Refiners in many nations continue to use over 3 grams of lead per gallon of gasoline. In the United States, refiners can use only 0.1 grams of lead per gallon. All gasoline produced in the U.S. must be no or low-lead. In the simplest possible terms, this means that the cheapest production method -- using lead -- is exhausted early in the refining process. After that, the cost of producing octanes without lead increases. The slow pace of lead phasedown in other nations has created a significant production cost advantage for foreign refiners of about 9 cents a gallon, or about $1.75 per barrel of crude oil processed (Charts G and H). Until foreign nations reduce their allowable lead usage, Congress must offset this foreign advantage if it wants an adequate U.S. refining industry.

5. Superfund Legislation Could Affect U.S. Refiners

Superfund legislation has not yet been finalized. U.S. refiners would prefer the imposition of a broad-based tax. Whatever form Superfund takes, it must recognize fuel and working capital costs.

The U.S. refining industry recognizes the need for a clean environment. However, from the competitive standpoint, the industry cannot afford a direct burden which foreign competitors in the U.S. market do not pay. These inequities promote refined product exports to the United States. Superfund, in its final form, must recognize the same fuel and working capital costs which the import fee legislation should recognize, or else the import fee needs to offset Superfund.

Summary of Offsets

Assuming that all imported products pay fees, we can summarize the offsets required for the U.S. refining industry to 1) break even on the crude oil import fee, and 2) recover environmental cost expenditures not borne by foreign refiners that compete in the U.S. market.

Because fuel and working capital costs vary with the absolute level of the crude oil fee, product fees should be proportional to crude oil fees if U.S. refiners are to break even under the fee. To offset the increased fuel cost, product fees need to be 10 percent more than crude oil fees. To offset the increased working capital costs, product fees need to be 1 percent more than the crude oil fee. Therefore, product fees must be at least 111 percent of the crude oil fee to offset operating cost increases caused by the legislation.

The 9 cent-per-gallon gasoline production cost disadvantage created by lead phasedown is equivalent to $1.75 per barrel of crude oil processed and is additive to the historical $.57 per-barrel air and water pollution control expenditure. Therefore, in addition to the 111 percent of feedstock fee, a $2.32 per-barrel environmental cost offset should be collected on all imported products to offset this artificial advantage.

In short, assuming that all imported products pay fees, product fees should equal 111 percent of feedstock fee plus $2.32 per barrel.

For example, a $7 crude oil import fee would result in a $10.09 per-barrel fee on products: $7.77 to recover fuel and working capital charges and $2.32 to offset higher U.S. environmental costs. For a $5 crude oil import fee, the product fee to allow U.S. refiners to break even would be $7.87 per barrel: $5.55 to recover fuel and working capital charges and $2.32 to offset environmental costs.

From the viewpoint of domestic refiners, the environmental offset is an absolute necessity whether import fee legislation is passed or not. It must be emphasized that the U.S. refining industry is asking only for an offset to legislation-induced cost increases. Adoption of these measures will not produce "windfall" refining margins.

6. Exemptions of Certain Products Would Mandate Changes in Bills

> **If any refined products are exempted or allowed to pay fees below the crude oil fee, the fee on the remaining product slate must be increased proportionately. Failure to do so would increase product imports at the expense of U.S. refining capacity.**

We do not support the exemption of any product import from a fee. We wish to emphasize that the cost offsets we have described are "breakeven" offsets. If any portion of the product barrel is exempted, the market price of the exempted product will be tied to the world oil price; U.S. refiners will be unable to recover any of the increased costs of producing the exempted products. Therefore, the fee on non-exempted products will have to increase proportionately as shown below, in order to avoid legislating economic losses for U.S. refiners.

Percent of U.S. Product Slate Exempted	Product Tax Formula Required for Breakeven
0	111 % of crude oil tax plus $2.32 per bbl
10	123 % of crude oil tax plus $2.58 per bbl
20	139 % of crude oil tax plus $2.90 per bbl
30	159 % of crude oil tax plus $3.31 per bbl
40	185 % of crude oil tax plus $3.87 per bbl
50	222 % of crude oil tax plus $4.64 per bbl

Obviously, the exemption of any product would cause the remaining products to bear a higher fee. If the crude oil fee was $7 per barrel today and no refined products were exempt, the product fee would have to be $10.09 per barrel. However, in drafting S. 1997, some products were exempted. By the time all the importers of kerosene, kerosene-jet fuel, diesel fuel, distillate, residual fuel oil, asphalt and road oil declare their product to be home heating oil, process fuel or residual fuel oil, 30 - 40 percent of the U.S. refined product slate could be exempt from both the crude fee and the environmental offset. If 30 percent of imported products paid no fee, the breakeven fee on remaining products would have to be $14.44 per barrel. In the 40 percent-exempt case, the fee on product imports would have to be $16.82 per barrel. Thus, the $3 per barrel environmental offset could be insufficient to avoid mandating economic losses for U.S. refiners.

This complication leads us to support no exemptions for any product imports. If exemptions must be granted, a fee should still be collected on all product imports -- with rebates provided to users of exempted products similar to what is proposed in S. 1507.

Summary Comments on S. 1507 and S. 1997

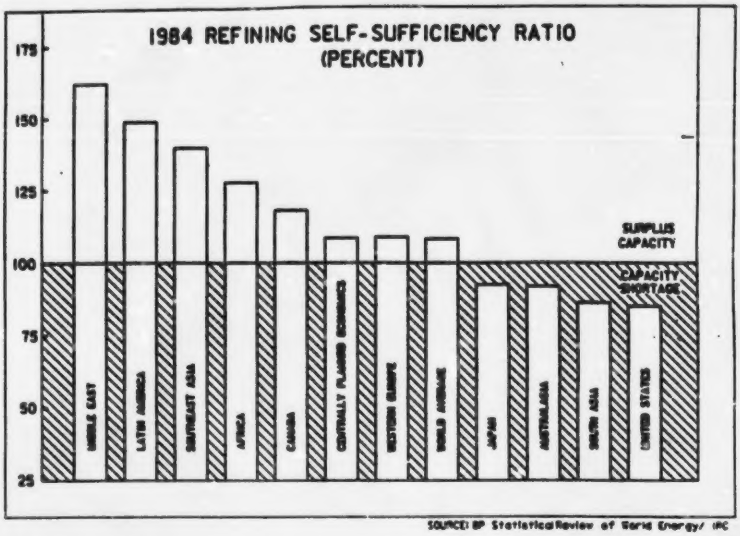
The impact of S. 1507 at low product and crude import prices is positive for U.S. refiners. This is true because the fee is collected on all crude oil and refined products as they are imported. The bill provides for rebates instead of exemptions, which will not disrupt U.S. refinery economics to the same degree as exemptions. In addition, at the current level of crude and product import prices, S. 1507 will effectively offset higher U.S. environmental costs. However, there are two problems with S. 1507: the impact on U.S. refinery margins is both unstable and unpredictable when crude and product prices are in the $25-$35 dollar range, and it does not assure the environmental offset, which is necessary regardless of price (Chart I).

To correct these problems, a provision requiring product fees to be no less than $2.32 per barrel greater than feedstock fees should be added to account for environmental and lead phasedown expenditures by U.S. refiners which are not borne by foreign competitors.

The effect of S. 1997 could be slightly positive at prices above $22 per barrel of crude oil. However, due to the exemptions on certain products, the $3 per barrel environmental offset can be inadequate, as we have explained (see Chart I again). This could be corrected by eliminating exemptions or by raising the fee in accordance with the portion of the product barrel which is not subject to the fee.

Thank you. We would be pleased to answer any questions you may have.

CHART A



SOURCE: BP Statistical Review of World Energy/ IRC

- Regional refining capacity as reported by BP was multiplied by 0.85 to allow for maintenance downtime, seasonal demand fluctuations and modest growth in refined product demand to get usable capacity.
- The usable refining capacity was divided by the regional oil consumption as reported by BP to determine the "refining self-sufficiency ratio."
- Regions with refining self-sufficiency ratios below 1.0 cannot refine all the oil they consume and have probably rationalized refining capacity to the point where national security is impaired.
- Using BP's data which overstates U.S. operating refinery capacity, the U.S.A. has the worst ratio of all regions.
- If we use the 1984 year-end U.S.A.capacity, our ratio becomes 80.
- Congress and the Administration need to begin an immediate national security (232) investigation of refined product imports and domestic refining capacity and formulate some sound energy policy.

CHART B

1984 U.S. REFINERY FUEL CONSUMPTION

	Physical Units	Million Btu's Per Unit	Million Btu's
Crude Oil	153,000 barrels	5.800	887,400
Distillate Fuel Oil	1,451,000 barrels	5.825	8,452,075
Residual Fuel Oil	18,814,000 barrels	6.287	118,283,618
Liquified Petroleum Gases	8,419,000 barrels	3.599	30,299,981
Natural Gas	573,330 MMcf	1,031	591,103,230
Still Gas	1,922,230,000 barrels	6.000	1,153,380,000
Marketable Petroleum Coke	1,950,000 barrels	6.024	11,746,800
Catalyst Petroleum Coke	65,666,000 barrels	6.024	395,571,984
Coal	347,000 short tons	24.230	8,407,810
Purchased electricity	29,354 million KWH	10,445	306,602,530
Purchased steam	30,635 million pounds	1,200	36,762,000
Hydrogen	793 MMcf	324	256,932
Other	1,527,000 barrels	5.796	8,850,492
			2,670,604,852

Energy used per barrel of refinery input	0.556
Energy used per barrel of crude input	0.606
Energy used per barrel of total gasoline produced	1.131
Energy used per barrel of net gasoline produced	1.258

SOURCE: DOE/EIA Petroleum Supply Annual 1984

- With the exception of natural gas, coal and purchased electricity and steam, the energy consumed comes directly from the feedstock.
    - 65 % of energy used changes as crude costs change
    - 35 % of energy used can be assumed to change with crude cost
- Should a tax be levied upon imported crude oil and feedstocks, U.S. refinery fuel costs will increase while foreign refinery fuel costs remain at world price levels.
- This creates a competitive disadvantage that Congress must offset should it enact a tax on imported crude and feedstocks.
- Product fees need to be at least 10 percent more than feedstock fees to offset increased fuel costs.

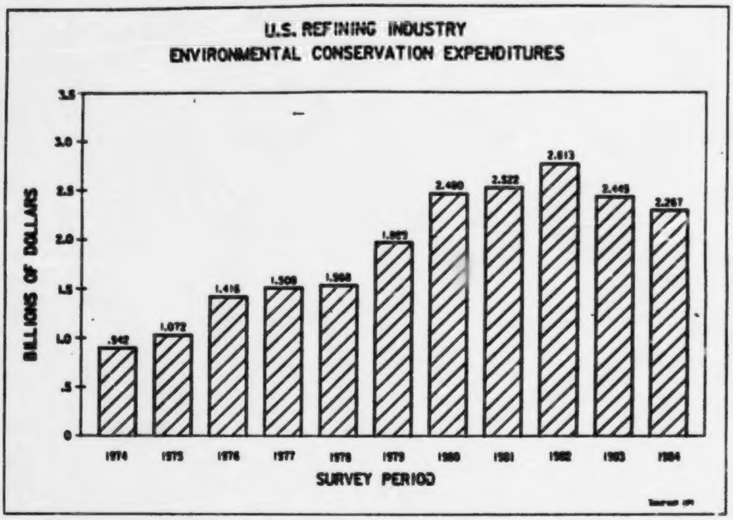
CHART C

WORKING INVENTORY REQUIREMENTS

DATE	STOCKS HELD AT REFINERIES (millions of barrels)	REFINERY CRUDE RUNS (millions barrels/day)	STOCKS HELD AT REFINERIES (days)
12-31-81	466.4	12.470	37.4
12-31-82	431.7	11.774	36.7
12-31-83	402.5	11.685	34.4
12-31-84	394.7	12.044	32.8
11-30-85	407.8	11.973	34.1
AVERAGE	420.6	11.999	35.1

- Refiners have large incentives to reduce stocks
  - high interest rates
  - expectations of falling oil prices.
- The failure to reduce stocks means these must be minimum working inventories.
- An import tax increases the cost of carrying this required inventory by 35 times the interest rate times the import tax.
- At a 10 percent interest rate, this translates into about a 1 percent increase in operating costs.
- Foreign refiners do not have to pay this cost and thereby gain a competitive advantage.
- Product fees need to be at least 1 percent more than feedstock fees to offset increased working capital costs.

CHART D



- The above pollution control expenditures are based upon individual oil company expenditures, as reported to the American Petroleum Institute.
- Since 1980 the refining industry has spent over $2.5 billion per year to preserve the U.S. environment.
- This is equivalent to 2.5 cents for every gallon of gasoline produced.
- Chart E shows that other countries pollution control expenditures are considerably less than this one industry's expenditure.
- This unilateral quest for a clean environment creates a competitive disadvantage that should be offset.

CHART E

POLLUTION CONTROL EXPENDITURES IN THE UNITED STATES, CANADA, JAPAN, AND WEST GERMANY, 1973-1982 (In billions of current dollars and as a percentage of gross domestic product)

	United States		Canada		Japan		West Germany	
Year	Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP
1973	4.9	0.36	0.13	0.10	1.8	0.45	NA	NA
1974	5.7	0.41	0.14	0.09	3.1	0.69	NA	NA
1975	7.0	0.46	0.14	0.08	3.2	0.64	1.0	0.24
1976	7.2	0.43	0.14	0.06	2.7	0.47	1.0	0.21
1977	7.3	0.38	0.05	0.03	1.7	0.22	1.1	0.18
1978	7.6	0.35	0.06	0.03	1.7	0.16	1.2	0.17
1979	8.4	0.35	0.09	0.04	1.2	0.13	1.2	0.15
1980	9.2	0.36	NA	NA	1.5	0.13	NA	NA
1981	8.9	0.31	NA	NA	2.0	0.17	NA	NA
1982	8.5	0.28	NA	NA	NA	NA	NA	NA

SOURCES: Congressional Budget Office. Exchange rates and GDP data from International Monetary Fund, *International Financial Statistics* (various years). Pollution control expenditure data for United States from Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (June 1981 and June 1983). Data for the other nations obtained from the respective embassies (1983).

- The data collected by the CBO is indeed spotty; but it shows that U.S. manufactures may be at a competitive disadvantage due to U.S. environmental preservation costs.

- Per EPA's estimate, U.S. costs will increase $2 billion per year under the new lead phasedown regulations.

- Regardless of one's beliefs concerning preserving our environment, one cannot expect a domestic industry to thrive when they have large operating cost components that foreign competitors do not face.

CHART F

	Maximum Lead Usage Rates		
	GMS/Liter	GMS/Gal.	Comments
Africa			
Nigeria	0.77	2.91	
Egypt	0.40-0.84	1.51-3.18	Depending on grade.
Others	0.84	3.18	
Middle East			
Iran	0.56	2.12	
Iraq	0.79	2.99	
Israel	0.42	1.59	
All Others	0.84	3.18	Talking about lead reduction, no timetable as yet.
Far East			
Japan	--	--	Essentially unleaded.
Taiwan	0.32-0.41	1.21-1.55	Depending upon grade.
India	0.56-0.80	2.12-3.03	Depending upon grade.
Pakistan	0.42-0.84	1.59-3.18	Depending upon grade.
Hong Kong	0.40	1.51	
South Korea	0.32	1.21	
Phillipines	0.28	1.06	
Others	0.84	3.18	
Australasia			
Australia	0.84	3.18	Beginning in 1986, new cars must use unleaded.
New Zealand	0.84	3.18	Going to 0.45 gm/l on 7-1-85.
Europe			
Portugal	0.64	2.42	Going to 0.4 gm/l on 1-1-86 to meet EEC standards.
Ireland	0.64	2.42	Going to 0.4 gm/l on 1-1-86 to meet EEC standards.
Spain	0.48-0.65	1.81-2.42	Depending upon grade.
Yugoslavia	0.60	2.27	
Czechoslovakia	0.40	1.51	
Iron curtain	Unknown	--	
Britain	0.40	1.51	Going to 0.15 gm/l on 1-1-86.
W. Germany	0.15	0.57	
Denmark	0.15-0.40	0.57-1.51	Depending upon grade
Austria	0.15	0.57	
Finland	0.40	1.51	
Norway	0.15-0.40	0.57-1.51	Depending upon grade
Italy	0.40	1.51	Bill pending to require 95 octane unleaded availability no more than 0.15 gm/l after June 1, 1986, unleaded priced 10 percent below leaded and and no more than 3 percent benzene content. Considering all unleaded later.
Sweden	0.15	0.57	
Switzerland	0.15	0.57	
Other Europe	0.40	1.51	Talking about change by 1989 will include some unleaded.
Western Hemisphere			
Canada	0.77	2.91	Will go to 0.29 gm/l on 1-1-87 recent average use was 0.49 gm/l.
Mexico	0.70	2.65	
Other Latin America	0.84	3.18	Some countries limit lead content of regular grade gasolines to 0.4 or 0.6 gm/l.
United States	0.03	0.10	Beginning 1-1-86.

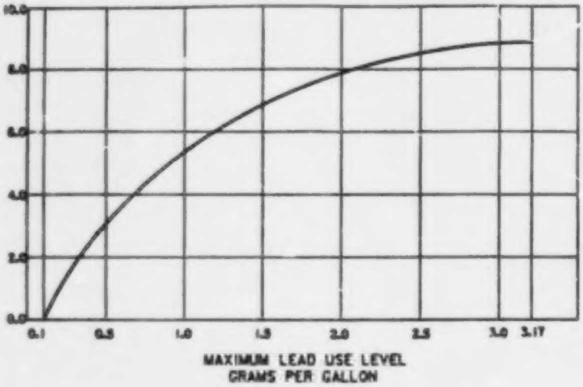
CH/er 09-24-85

CHART G

FIGURE 4

COMPETITIVE DISADVANTAGE CREATED BY U.S. LEAD PHASEDOWN

(CENTS PER GALLON GASOLINE)



- The above competitive disadvantage is based upon the following assumptions:

  -typical lead response in gasoline blending
  -lead cost of 0.7 cents per gram
  -U.S. octane cost of 1 cent per gallon octane.

- The cost of reducing the allowable U.S. lead usage from 1.1 to 0.1 grams per gallon is between 5 and 6 cents per gallon.

  -justifies trading value of lead rights
  -consistent with EPA's cost analysis

- The disadvantage increases as the maximum lead use level of the producing country increases.

  -at 3.17 grams uer gallon of lead usage, the disadvantage is almost 9 cents per gallon
  -this will cause foreign refiners to produce gasoline for the U.S. market and cause more U.S. refiners to shut down.

- Combine this disadvantage with the pollution expenditures and proposed $3 per barrel the environmental offset fee in the Wallop-Bentren Energy Policy, legislation may need to be increased.

CHART H

HOW U.S. LEAD PHASEDOWN PROVIDES AN ADVANTAGE TO FOREIGN GASOLINE AND BLENDSTOCK SUPPLIERS IN THE U.S. MARKETPLACE

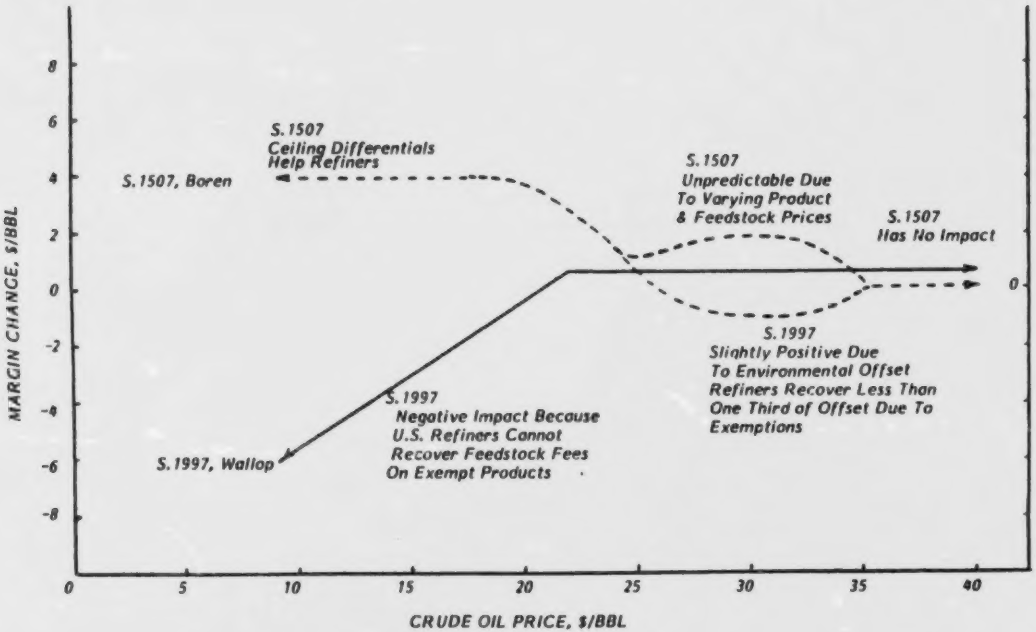
To produce 89 octane leaded regular gasoline for domestic consumption, a foreign refiner using 3.18 grams of lead per gallon starts with a blend of unleaded gasoline components with an octane of 77. By adding lead, he can create the remaining 12 octanes to reach the 89 octane level for about 2 cents worth of lead.

The U.S. refiner, who can use 0.1 grams of lead per gallon, can get only one lead-derived octane and must have a blend of unleaded components with an octane of 88. To make up the 11 octane difference with unleaded gasoline blends, the U.S. refiner must resort to high cost technologies which create octanes at costs in excess of one cent each.

The foreign refiner simply buys about 2 cents worth of lead to use in his domestic product and then, at no extra cost, simply changes the set points on the valves that divert high octane components to a high octane tank and low octane components to a low octane tank, to which he adds the lead. Thus, the foreign refiner is able to set aside an 88 octane blend of unleaded components that cost him only 2 cents per gallon in additional production costs. The foreign refiner then competes head-on with the lead-limited U.S. refiner who is spending over 11 cents in additional processing costs to get an equivalent blend.

CHART I

IMPACT OF PROPOSED LEGISLATION
ON 1984 AVERAGE U.S. REFINER



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STATEMENT OF CARL BOLCH, JR., PRESIDENT, RACETRAC PETROLEUM, AND FIRST VICE PRESIDENT, SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA, ATLANTA, GA

Senator WALLOP. Mr. Bolch.

Mr. BOLCH. Mr. Chairman, my name is Carl Bolch, Jr. I am chairman of the board and president of Racetrac Petroleum in Atlanta, GA. We operate retail gasoline stations in 12 southern States.

I appear today on behalf of SIGMA, the Society of Independent Gasoline Marketers of America. SIGMA is opposed to any tax on imports, and, in particular, to any differential imposing a higher tax on petroleum products than on crude oil.

Independent marketers and chain retailers are the most price competitive segment of the retail gasoline market. SIGMA's members obtain much wholesale supply from the same refiners against which we compete. Access to foreign products is the most important factor which assures that competitively priced wholesale product is available. Imports function as an addition to total supply. More important, imports induce competitive pricing by domestic refiners.

An oil import tax is not sound energy policy. It is an invitation to repeat the mistakes of the past. The mandatory oil import program of the 1960's distorted the free market. It shielded the domestic industry from competition and encouraged the depletion of domestic reserves. It limited supplies of imports and, thus, reduced our access to competitively priced gasoline.

By protecting domestic companies from world competition, this program resulted in higher prices and created a vast bureaucracy charged with its administration as well as an additional bureaucracy for granting exceptions.

The policies of the 1960's laid the groundwork for the oil crisis of the 1970's. Import controls were lifted in the spring of 1973 because they had caused severe domestic shortages. America then rushed out into the world market. Before supplies could adjust, the Arabs recognized our vulnerability and took advantage of it.

Aided by price and allocation controls, worldwide prices of crude oil spiraled upward throughout the 1970's until President Reagan decontrolled oil in 1981. World crude prices began to erode and have been falling ever since. The shortages of the 1970's were not physical shortages. Government interference caused market distortions. Since deregulation, independent marketers have had access to competitively priced supply and our efficiencies have enabled us to become the most competitive sector of the oil industry.

Why do some in the industry advocate an import tax? Only one reason; they want an advantage for themselves.

Certain refiners are trying to tilt the playing field in their direction by restricting imports. The decline in U.S. refining capacity since 1981 has not been caused by imports, but by overcapacity and reduced demand. The only refineries that have closed have been the small, inefficient refineries, many of which were created to take advantage of the regulatory incentives of the 1970's. Far from flooding the market, gasoline imports are less than 6 percent of U.S. consumption and falling.

SIGMA is particularly opposed to a differential oil import tax imposing a higher level on gasoline than on crude oil because it would foreclose imports as a supply source. Furthermore, American Petroleum Institute studies indicate that refiners' environmental costs do not justify any additional differentials.

In conclusion, the availability of imports is crucial to our competitive viability. Our access to imports keeps domestic refiners honest.

SIGMA does not support any energy taxes. However, if Congress must impose an oil tax, there are more equitable ways than an import tax. For example, an equal tax could be imposed on all refined products, both domestic and imported. Or the Federal excise tax on gasoline could be increased. An excise tax would permit efficient retailers to continue serving as a downward influence on gasoline prices.

If an oil tax must be imposed, these alternatives are preferable to an import tax because they do not disturb a level playing field in the petroleum business. Such measures would preserve the competitively neutral conditions that exist today in the oil industry from which our Nation has benefited so much since 1981.

Senator WALLOP. Thank you, Mr. Bolch.

[The prepared written statement of Mr. Bolch follows:]

United States Senate
Committee on Finance
Subcommittee on Energy and Agricultural Taxation

Statement of Carl Bolch, Jr.
on Behalf of the Society
of Independent Gasoline Marketers of America

My name is Carl Bolch, Jr. I am Chairman of the Board and Chief Executive Officer of Racetrac Petroleum, Inc., of Atlanta, Georgia, and First Vice President of the Society of Independent Gasoline Marketers of America, on behalf of which I appear today. My company, Racetrac Petroleum, Inc. owns and operates 250 retail gasoline outlets in twelve Southeastern states. SIGMA is a national trade association comprised of 282 independent marketers and chain retailers of motor fuels. SIGMA's members market refined petroleum products in all 50 states and account for approximately 20 percent of the U.S. retail market for motor gasoline.

The purpose of these hearings is to review proposals to impose a tax on imported oil, and specifically to review bills introduced by Senators Wallop (S. 1997) and Boren (S. 1507). Senate bill S. 1997 would impose a tax on the importation of crude oil and refined petroleum products which would be triggered whenever the world price of crude oil fell below $22.00 per barrel. The tax would equal the difference between the world price of crude oil and the $22.00 benchmark. In addition, the bill would impose an additional $3.00 tax on imports of petroleum products. Senate bill S. 1507 would increase the present tariff on imported crude oil by up to $5.00 per barrel and the tariff on imported petroleum products by up to $10.00 per barrel.

The Role of Independent Marketers and Chain Retailers in the Oil Industry

Independent marketers and chain retailers compete not only directly with one another, but also with the downstream marketing and retailing operations of refiners. Independent marketers and chain retailers have had a beneficial impact on price competition in the retail gasoline marketplace. We have introduced such innovative marketing devices as self service, high volume/low margin marketing, and automated retail marketing. These pioneering marketing concepts and superior systems of cost controls have induced price competition in the domestic market for gasoline. Independent marketers and chain retailers historically have been recognized as the most price competitive segment of the retail gasoline market.

We neither produce nor refine crude oil. Thus, we are entirely dependent upon third parties for our sources of supply. The prices at which we can obtain refined petroleum products are critical. In the absence of competitively priced products, the efficiencies and innovations of independent marketers and chain retailers would be largely irrelevant, and we could not survive.

The Relationship Between Independent Marketers and Their Supplier-Competitors

SIGMA's members compete directly at the retail level with refiners which market the petroleum products that they refine. We obtain much of our supply of product at wholesale from the same refiners against which we compete. Therefore, in the current market, access to foreign products is the single most important factor which assures that competitively priced product will be available.

Access to foreign product assures the existence of competitive wholesale market products in two ways: (1) imports function as an obvious addition to total supply; and, more importantly; (2) the availability of foreign products to participants in the U.S. market induces competitive pricing by domestic refiners who otherwise would have no incentive to deal on a competitive basis with their marketer-competitors. Indeed, access to foreign markets (and not the volume of such product actually imported) constitutes the principal incentive for refiners to sell us competitively priced products. Absent this incentive, competition at the retail level of the gasoline market would be reduced significantly.

Inadvisability of an Oil Import Tax

SIGMA is opposed to any tax on imports of crude oil and petroleum products, and in particular, to any differential which imposes a higher tax on petroleum products than on crude oil. Proponents of an oil import tax have attempted to justify such a tax on the following grounds. First, they have proposed an oil import tax with a differential as a means of protecting the domestic refining industry. Second, the tax has been hailed as a way of ensuring the U.S. national security. Third and more recently, a tax on crude oil and products has been advanced as good energy policy. Fourth, and especially since the enactment of Gramm-Rudman-Hollings, proponents of an oil import tax on crude oil and products have suggested it as a possible revenue raising measure.

There are many reasons why each of these purported justifications for an oil import tax cannot be sustained. Appendix A which is attached outlines the reasons why an oil import tax is not an efficient revenue raising tool or an effective means of ensuring U.S. energy independence and national security. My testimony, however, will address only the issue about which SIGMA is most knowledgeable, that is, the effects of an oil import tax on gasoline marketing.

From the standpoint of the independent marketer, there is no question that the present policy with respect to imports is the soundest. For the first time in decades, U.S. energy policy is essentially neutral with respect to imported crude oil and petroleum products. The present policy, by removing government intervention, has provided a level playing field for all sectors of the oil industry. By dismantling many of the governmental protections previously afforded to crude oil producers and refiners, we have allowed the forces of supply and demand to operate, thereby minimizing market distortion. The effects of deregulation have been beneficial. Prices of oil have declined. U.S. sources of supply are diversified and much more secure than in the 1970s. 1/ That is a far cry from the situation in 1977, when 43 percent of our crude and product imports came from suppliers in the Middle East.

Nevertheless, proponents of an oil import tax would alter present U.S. policy by again injecting government regulation into the marketplace. Proponents of a tax have attempted to justify this government intervention on the ground that the absence of controls on oil imports could lead to dependence on imported energy. They argue that an oil import tax would be an effective policy for preventing such dependence because a tax will stimulate domestic exploration and exploitation of new reserves and reduce domestic consumption.

An oil import tax, far from being sound energy policy, is an invitation to repeat the mistakes of the past. The lessons of the last four decades demonstrate that a competitively neutral policy is the soundest. In introducing his bill, Senator Wallop correctly stated that "to ignore the disruptive and inflationary results of our past failures in energy planning . . . would be irresponsible." An examination of our energy policy in the 1960s and the 1970s should be enough to convince us that the present neutral policy is far sounder.

In the 1960s, when foreign oil was cheap and could be purchased at close to its economic cost of production, U.S. policy discouraged imports of oil. The Mandatory Oil Import Program, which was adopted at the behest of U.S. crude producers, restricted the volume of oil imports to a level based on imports just prior to enactment. This program

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1/ Today, nearly 60 percent of U.S. imports of crude oil and petroleum products comes from suppliers in the Western Hemisphere. Only 9 percent of crude and product imports comes from Middle Eastern suppliers.

was justified to the American public as necessary to "meet the national defense requirements of the United States." In fact, the program distorted the free market by shielding the domestic industry from competition and encouraging the exploitation of domestic reserves.

The Mandatory Oil Import Program had a particularly negative impact on independent marketers and chain retailers. The program limited supplies of imported petroleum products and thus reduced independent marketers' and chain retailers' access to competitively priced motor fuels. Oil import controls caused a number of independent marketers and chain retailers to suffer considerable losses. Many marketers and chain retailers were on the edge of bankruptcy because of the limited access to competitively priced supply.

The Percentage Depletion Allowance, first enacted in the 1920s and continued through the 1960s and early 1970s permitted U.S. producers to deduct from their gross taxable income 27.5 percent of gross sales from domestic crude oil production. (This percentage was reduced to 22 percent in 1969.) Integrated oil companies were allowed to deduct this percentage from the internal transfer price to their own refineries. The internal transfer price was set with little regard to arms-length transactions and quite naturally became the highest price the integrated company could justify to the tax auditor. Inevitably, integrated companies had high transfer prices for crude, with resulting high percentage depletion allowances. Profits were concentrated at the crude oil level, causing certain integrated companies to support continued import controls.

The Percentage Depletion Allowance, like the Mandatory Oil Import Program, had a negative impact on independent marketers and chain retailers. The allowance created market distortions because it permitted disproportionate profitability at the crude production level. Integrated companies used refining and marketing as simply the vehicles for disposing of crude oil production rather than concerning themselves with earning refining and marketing profits. With integrated companies selling their product at extremely low margins, independent marketers and chain retailers--which had limited access to imported petroleum products--were hard pressed to remain economically viable.

The effect of these programs was to drain America first, leaving smaller, more costly reserves available at home for the future. While this occurred, cheap foreign oil that should have been exploited first — before our reserves -- was not exploited by the United States. In addition, these programs resulted in higher retail oil prices than would otherwise have been the case.

These programs also resulted in the creation of a vast federal bureaucracy charged with their administration. The Mandatory Oil Import Program, for example, necessitated an extensive and complex administrative apparatus to implement its essential features, namely, control of imports through a quota with allocations to individual U.S. importers. A set of complex rules and regulations became necessary to determine precise individual allocations. These allocations, which were implemented through a licensing procedure, were based on a number of factors including historical importing levels, and percentage of "refinery inputs" reported. The allocation rules inevitably gave rise to an apparatus for granting exceptions based on hardship or other factors. The Oil Import Appeal Board was created to determine the appropriateness of requests for exceptions as well as to decide other questions relating to individual allocations. The result of the oil import program was to put the government in the business of policing oil imports and to impose a complex system of regulation on an industry that, prior to the 1960s, had been relatively free of government controls.

The policies of the 1960s laid the groundwork for the oil crises of the 1970s. Restrictions on imports under the Mandatory Oil Import Program, coupled with price controls imposed by President Nixon in 1971, created shortages in the United States and enormous pent-up demand. When President Nixon lifted import controls in 1973, America's oil industry quickly sought to import large quantities of crude oil from foreign producers that were unprepared to meet such increased U.S. demand. In effect, by attempting to isolate the United States from world crude oil markets, government intervention had made the country critically dependent on these markets during a period of burgeoning demand.

The government regulation of the 1970s again ensured the existence of a vast and expensive government bureaucracy. As with the Mandatory Oil Import Program, price and subsequently imposed allocation controls necessitated the creation of an extraordinarily complex set of regulations and procedures for determining price limits and product allocations in individual cases. These programs also inevitably gave rise to their own bureaucracy and another complex set of regulations for granting exceptions. The result was to involve the government in policing oil prices and allocation.

When Arab OPEC nations imposed an embargo in the fall of 1973 in retribution for our policies in the Arab-Israeli conflict, the United States was vulnerable. Price and allocation controls, based on historical levels of usage, restricted the movement of those petroleum products that were available in this country. The result was regional shortages that were the consequence not of physical shortfalls, but of government regulation. The same situation also occured in 1979, following the Iranian revolution. On both occasions, shortages occurred because U.S. producers could not totally replace the disrupted supplies. Import controls in the 1960s and early 1970s, by removing the United States from world oil commerce, had made us unnecessarily vulnerable to political pressures surrounding oil supply and had caused the United States to deplete much of its reserves with no consequent strategic or political benefit.

Worldwide prices of crude oil spiraled upward until they reached a peak in early 1981, when President Reagan dismantled price and allocation controls. World crude prices immediately began to erode and have been falling ever since. The so-called shortage of the 1970s was revealed for what it really was--not a physical shortage, but a market distortion created by government interference.

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Currently, with the price of oil drifting down towards the economic costs of production, certain interest groups again are calling for a policy restricting imports. Such a policy inevitably would cause distortion in the U.S. and world oil markets as it did in the 1960s and 1970s. U.S. producers would be encouraged to deplete remaining U.S. reserves, while cheaper foreign oil would not be consumed. The stage once again would be set for a price explosion similar to that which occurred in the 1970s.

A neutral policy with respect to imports not only is better energy policy, but also is a necessary condition for independent marketers to compete. Before import controls on finished product were lifted in the 1970s, many independent marketers were not profitable because of difficulties in obtaining competitively priced supplies. With only limited imported product available, domestic refiners had less incentive than at present to sell their motor fuel to independent marketers at competitive prices. As a result, we were at a significant disadvantage vis a vis other sectors of the industry and were less able to compete effectively.

During the five years since deregulation, independent marketers have had access to competitively priced supply and have been able to capitalize on their functional efficiencies to become the most competitive sector of the oil industry. Consumers have been able to realize significant savings in their energy bills and have been able to reallocate their spending in a way that has permitted economic growth. Instead of making already wealthy oil companies richer (as would an oil import tax), the current competitively neutral policy has encouraged resource allocation in a much more productive and beneficial manner.

In reality, it is impossible to determine a uniform tax on crude oil and refined petroleum products, such as gasoline, since all crude oil is not fungible. For example, there is sweet crude, sour crude, heavy crude and light crude. Moreover, the finished products into which a barrel of crude oil can be refined cover a vast array. While in theory it may be possible to establish a tax on finished product imports and crude imports that are equivalent, in reality such taxes would create a labyrinth of choices between importing crude oil and various finished products. Such choices would be subject to continual revision as markets for the various crude oils and finished products change. In addition, they would not necessarily reflect the true economic differentials of the crude oil or finished product imports. Accordingly, crude and finished products cannot be treated uniformly for tax purposes.

Nevertheless, a differential tax imposing a higher levy on imports of petroleum products than on crude oil would be even more detrimental to independent marketers and U.S. consumers. Such a tax would virtually eliminate product imports and thus cause our efficiencies to become less relevant. With competition from independent marketers gone, domestic refiners would have little incentive to lower their gasoline prices below the after-tax level. U.S. consumers would join SIGMA members as principal losers, while domestic refiners would benefit enormously.

An oil import tax (either uniform or with a differential) would distort the petroleum product market in an additional but more subtle way. By causing an increase in domestic and imported crude prices, a tax could prompt the integrated oil companies to make decisions regarding downstream product pricing that do not reflect market considerations. Without government intervention, it should be in the interest of integrated companies to make a profit at each stage of their operations. The import control and percentage depletion allowance programs of the 1960s and 1970s, however, permitted integrated companies to concentrate their profits at the crude oil production stage and place little emphasis on developing competitive refining and marketing operations.

An oil import tax similarly would lessen the integrated companies' incentive to increase the efficiencies and profitability of their refining and marketing operations. A tax would increase the price of domestic crude oil significantly, and thus permit integrated oil companies once again to concentrate profits at the crude oil production level. As a result, integrated oil companies would be able to sell their own refined products with little concern for the profitability of their downstream operations, in order simply to move their petroleum product inventories. The downward pressure on product margins caused by such market distortion would penalize marketers and chain retailers. With increased supply costs (also due to the effects of the tax), we again would be hard pressed to remain economically viable.

Certain refiners have urged an oil import tax on petroleum products on the ground that the domestic refining industry needs protection from petroleum product imports. These refiners are not interested in a level playing field between the domestic and foreign refining industries, but rather in one clearly tilted in their direction. The cost of such protectionism would be enormous. More importantly, imports are not the source of those domestic refiners' problem.

The cause of the decline in U.S. refining capacity since 1981 has been the change in conditions in the U.S. refining market. Prior to 1981, the entitlements program and crude oil price controls created incentives for the construction and expansion of domestic refining capacity. Domestic price and allocation controls directed the development of the domestic industry while OPEC policies dominated the foreign crude and refining markets. Construction of new facilities outpaced growth in product demand, leading to a capacity surplus in 1980 for the first time since 1962.

With decontrol in 1981, free trade and competition returned as the norm to an industry that had learned to look to the government for the establishment of goals and incentives. The result was a rude shock to all within the petroleum industry -- crude producers, refiners and OPEC member states. The resulting overcapacity in crude production and refining capacity is well-documented and, in fact, admitted by those seeking protectionist legislation. It is generally acknowledged that a rationalization process has been taking place in the form of closing small inefficient refineries as well as older refineries not possessing state-of-the-art technology. The process is continuing and is the natural result of a marketplace adjusting to lower demand while overcapacity continues to exist. There is no question that in this period of adjustment between declining demand and overly optimistic construction of new refineries, there will be financial victims. The likely victims will be the inefficient and financially weak refineries that are unable to compete in the absence of government intervention and artificial support.

Those seeking protectionist legislation would like you to believe that their problems are being caused by an overwhelming flood of imports. The facts show that the reduction in U.S. refining capacity during the past five years is not the result of petroleum product imports. At a time when the United States is experiencing an increase in foreign manufactured imports, finished motor gasoline imports constituted only 5.5 percent of U.S. consumption during 1985. U.S. imports of total finished petroleum products averaged only 8.6 percent of U.S. demand for the first eleven months of 1985. Excluding residual fuel oil, finished product imports fell from 6 percent in 1984 to 5.5 percent for January through November 1985.

Much is made of the number of refineries which have closed since January 1981. Most of the refineries that have closed since 1981 are those small refineries that benefitted from government protection in the 1970s. Thus, over 85 percent of the 111 refineries reported to have ceased production as of January 1, 1985 were refineries with less than 50,000 barrels per day production capacity. Seventy-five had a capacity of 30,000 barrels per day or less. Forty-four of those refineries were opened immediately prior to or during the period of small refiner protection. Preliminary figures from the U.S. Department of Energy show that eleven more refineries closed during 1985. (In addition, six new refineries were opened or reactivated.) Ten of the eleven refineries that closed had a capacity of less than 30,000 barrels per day. [2] The vast majority of other refineries that have closed since 1981 have been older outmoded plants. These facilities have not been efficient enough to be economically viable in a deregulated highly competitive market, particularly as demand has both declined and shifted away from residual fuels (which the older, inefficient refineries could produce profitably) to lighter products. 3/ The trend in U.S. refinery closures has reflected a worldwide trend since the early 1980s as petroleum product demand has declined and shifted worldwide.

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[2] U.S. Department of Energy, Energy Information Administration, Petroleum Supply Annual 1984, Vol. I (1985); Petroleum Supply Monthly, November 1985 (January 1986).

Those refiners that are efficient generally were quite profitable in 1985, at a time when imports purportedly were threatening U.S. refining capacity. During the first and second quarters in 1985 all of the largest thirteen integrated and independent refiners except one earned sizable profits. In addition, eight of the thirteen principal refiners reported increased profits from the first quarter to the second quarter of 1985. During the third quarter of 1985, eleven of the thirteen major refiners were profitable, and five of these companies reported net gains from the second quarter.

Certain refiners point to imports of products from Arab OPEC refineries, arguing that they constitute a threat from which the U.S. industry needs protection. There is no indication of any such threat in the foreseeable future. 4/ Even if an additional 1 to 1.2 million barrels per day of petroleum products were added to the world's supply, there would be little if any displacement of U.S. or other refinery

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3/ A table compiled by the U.S. Department of Energy which shows refinery closures by refining capacity is attached as Appendix B. Also included in Appendix B is a copy of a report issued in December 1985, by the Harvard University Energy and Environmental Policy Center, which analyzes recent refinery closures by plant capacity and efficiency.

4/ Indeed, a study recently prepared for the U.S. Department of Energy concluded that the present level of imports from Saudi Arabia cannot possibly be regarded as a national security threat. *See*, Resource Systems Institute, East-West Center, *The Changing Structure of the World Refining Industry: Implications for the United States and Other Major Consuming Nations* (Prepared for U.S. Department of Energy) (Feb. 1985), at vi, 58. *See also* Appendix A, attached hereto.

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capacity. Such an increment represents only about 3 percent of the current free world demand of approximately 46 million barrels per day. 5/ More importantly, all indications are that product imports into the United States from the Middle East will remain at relatively low levels. Despite the opening of several new refineries, imports from these sources are at low levels and have not increased appreciably. Product imports from Saudi Arabia, for example, were only 2 percent of total imports through the first eleven months of 1985. Indeed, far from increasing their production, the Saudis have taken steps to curtail their product output. Thus, Saudi refiners recently have postponed indefinitely plans for two new refineries, at Riyadh and Ras Tanora, that would have expanded production capacity by 450,000 barrels per day.

Several factors militate against any significant increase in Arab OPEC imports. First, the natural market for these products will be Western Europe and Japan, and not the United States. The sale of products at official prices (or less) in the U.S. market will result in fewer profits to Arab OPEC refiners because of the high cost of transportation, thus discouraging significant exporting to the United States. 6/ Second, it appears likely that more profitable Western European and Japanese markets will exist for Arab OPEC exports during the foreseeable future. Western European members of the International Energy Agency ("IEA") have pledged to maintain a free market for petroleum product imports. Recent actions on the part of the Japanese government suggest that traditional barriers to light product imports in that country will be removed.

5/ Impact of Imported Petroleum Products on the Domestic Petroleum Industry, Hearing Before the House Committee on Energy and Natural Resources, Subcommittee on Energy Regulation and Conservation, 99th Cong., 1st Sess. (June 4, 1985) (Testimony of Danny J. Boggs, Deputy Secretary, U.S. Department of Energy), at 18.

6/ In addition, there is no indication that imports into Western Europe of petroleum products from Saudi Arabia will displace production in those countries, and thus cause increased product exports from Western Europe to the United States. A recent report prepared by E. B. Brossard, Director of Policy Analysis for the Louisiana State University Center for Energy Studies concluded that Mobil Corporation's share of the new Yanbu refinery's production will primarily be used to fill the gap left by the closing of Mobil's Wilhelmshaven, West Germany refinery. The Oil Daily, October 23, 1985, at 2.

In short, there appears to be no basis for enacting an oil import tax as a means to protect the U.S. refining industry. Such a measure would have a negative impact on independent marketers and chain retailers, without accomplishing the purpose for which it was intended. Contrary to the assertions of certain refiners, the U.S. oil industry as a whole would be better served by a policy that continued to allow the free market to operate.

Finally, history has shown that oil import taxes and quota programs inevitably spawn a vast, expensive and inequitable government bureaucracy. The bureaucracy required to administer such programs as the Mandatory Oil Import Program is a case in point. The complex regulations and exceptions procedures created under that program constituted unnecessary government intervention in an industry that would have served U.S. consumers far better had it been left unregulated. Adoption of an oil import tax would necessitate the re-establishment of a similar administrative apparatus to implement the tax and to deal with the inevitable exception requests. Indeed, some of the legislation that has been proposed already envisions exemptions from the tax's application. Senator Boren's bill, for example, would exempt heating oil and oil intended for producers of U.S. exports. The likely difficulties that would be encountered in determining how to apply such exemptions are reminiscent of the complex and involved regulatory problems that arose under the Mandatory Oil Import Program and price and allocation controls.

The expense, and administrative burdens of renewed regulation of oil imports hardly seem justified in light of the considerable disadvantages of government intervention in the marketplace. Only with a neutral policy with respect to oil imports can this country enjoy the benefits of low-priced energy, without the negative effects of government intervention in the market.

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Inadvisability of a Differential Tax on Oil Imports

SIGMA is particularly opposed to a differential oil import tax imposing a higher level on finished products than on crude oil because such a measure would be especially injurious to independent marketers and chain retailers and to U.S. consumers, while benefitting only a narrow sector of the U.S. economy. A differential tax would weaken our competitive position by foreclosing imported products as a source of supply. The higher levy on product imports would price us out of the market. With imports gone, domestic refiners would have little further incentive to sell motor fuels to independent marketers and chain retailers at competitive prices. In the absence of competition from independent marketers and chain retailers, domestic refiners could raise their gasoline price considerably, even after paying an increased amount for the crude oil that they purchase and refine.

It is not surprising that certain independent refiners are strongly in favor of such a measure. Indeed, a differential tax is the only measure that would be to the independent refiners' advantage. They cannot support a uniform tax because such a measure would increase independent refiners' production costs without permitting them to make any additional profit and at the same time would grant to the integrated competitors a significant advantage.

Predictably, virtually the only proponents of a differential tax are the independent domestic refiners. They stand to gain enormously from such a measure, but at what cost? The imposition of a higher tax on petroleum products including gasoline would be a significant blow to consumers and to independent marketers. Such a trade restraint would raise the price of gasoline in an amount equal to the tax. Moreover, the price of petroleum products including gasoline and other motor fuels would be increased additionally by an amount equal to the value of the independent marketers' efficiencies rendered less relevant by the tax. Since imports are not the cause of refiners' problems, a differential cannot be viewed as necessary to protect the industry from foreign competition. Its real purpose is to alter the present competitively neutral conditions in the oil industry, at the expense of independent marketers and U.S. consumers.

The domestic refining industry has argued that it needs a higher levy on refined products to meet its special "environmental costs" and thus stay competitive. Senator Wallop has suggested that the independent refiners' contention may have some basis. In his floor statement introducing his oil import tax proposal, Senator Wallop stated: "America's refineries are subjected to environmental requirements not placed on their foreign competition, and to the extent that these can be quantified and equalized within the excise tax we should do so." Senator Wallop's bill contains a $3 differential designed to offset refiners' "environmental costs."

There appears to be no basis for such an additional differential to cover U.S. refiners' environmental costs. Based on data from the American Petroleum Institute, 7/ it is difficult to believe that refiners' environmental costs total the amount of differential sought. API's figures indicate that total environmental expenditures for manufacturing, including capital and operating and administrative expenses amounted to less than 60 cents per barrel over the ten year period ending in 1983. These figures are based on responses to an American Petroleum Institute questionnaire from companies representing 77 percent of U.S. refining capacity. The 60 cents per barrel figure includes expenditures (such as those to ensure compliance with the Clean Air and Water Acts) required of all U.S. refiners. It also includes expenditures (such as those connected with production of unleaded gasoline) required by U.S. law of all refiners, foreign or domestic, who intend to sell in the U.S. market. If these latter environmental expenses are excluded, the cost per barrel to U.S. refiners would be even less than the 60 cents per barrel indicated by the refining industry itself. The current tariffs on many refined products already provide a substantial offset to such costs. For example, the present

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7/ American Petroleum Institute, Environmental Expenditures of the United States Petroleum Industry 1974-1983, Publication No. 4384.

tariff on motor fuel imports of 52.5 cents per barrel would appear to permit domestic refiners to cover most or all of the environmental costs associated with the refining of gasoline.

API figures also indicate that refiners' total environmental expenses, including research and development, amounted to no more than 65 cents per barrel over the ten year period ending in 1983. This figure again is much less than the differential tax which U.S. refiners claim they need to offset environmental costs. It seems more likely that the refiners' articulated reason for a differential is simply a pretext to gain an advantage over other more competitive sectors of the oil industry.

Conclusion

In conclusion, it is important to understand the role that imports play in the operation of the domestic motor fuels market. The availability of such products is crucial to the competitive viability of the independent marketers and chain retailers, not because imports actually provide substantial volumes of supply, but because the availability of foreign products as an alternative source of supply serves as the principal inducement to domestic refiners to sell competitively priced motor fuels to their marketer-competitors.

An oil import tax would cause a disruption in the supply of imports that independent marketers need both to stay competitive and to provide the benefits that functional efficiencies enable them to afford to U.S. consumers. At this juncture, the American people would be better served if Congress preserved the level playing field that our current neutral import policy has brought us. U.S. consumers have gained, U.S. industry has gained, and the U.S. economy has gained. There is no good reason to alter present market conditions with measures, such as an oil import tax, that provide far fewer benefits than the costs they impose.

Despite the disadvantages of an oil import tax, it has been suggested that at least some sort of additional tax will be needed over the next several years to help ensure a decline in the budget deficit.[8] SIGMA does not support imposing energy taxes of any kind as a means of raising general revenue for the U.S. Treasury.

If Congress must impose an oil tax, there are measures other than an oil import tax which would be more equitable and have less of an adverse impact on consumers and the petroleum products marketing industry. One such measure would be an equal tax on domestic and imported products. Under this approach, a tax would be imposed at two points in the petroleum product supply chain: (1) on domestically refined products at the point of sale of the products by the refiner; and (2) on imported products at the point of importation.

The economic effect of this product tax would be similar to the effect of an equal tax on domestic and imported crude oil and petroleum products. However, this approach would maintain competitively neutral conditions in the domestic market because it would affect entities relying on imports in the same manner as it would affect entities relying on domestic product without the problems that would arise because of the different types of crude oil and product. Independent marketers and chain retailers would not be disadvantaged vis a vis their competitors, apart from losing a certain volume of sales due to the likely decline in demand caused by increased prices.

8/ This suggestion, however, is undercut by recent findings of both the Office of Management and Budget ("OMB") and the Congressional Budget Office ("CBO"). See "Economists Now Detect Falling Trend in Deficit," The New York Times, February 20, 1986; "Declining Deficits: The Little-Told Story," The Wall Street Journal, February 11, 1986; Congressional Budget Office, The Economic and Budget Outline: Fiscal Years 1987-1991 (February 1986). These findings project that the budget deficit will decline by approximately 50 percent, even if existing government programs are maintained, and real-GNP and unemployment rates prove to be as previously forecast. Thus according to OMB, the deficit in 1991 will be only $104 billion. CBO has concluded that the 1991 deficit will total $107 billion. According to these agencies, the reduction will be attributable to several factors, including an unprojected drop in interest rates, the cumulative effect of the $11.6 billion removed from the federal budget under Gramm-Rudman-Hollings and a planned reduction in defense spending over the period 1986-9. These projections suggest that there will be little need for an additional oil tax in the years to come.

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A second alternative measure would be an increase in the existing federal excise tax on the sale of gasoline. An excise tax would not affect any commodity other than gasoline. Prices of crude oil and other petroleum products would not be affected because they do not compete with gasoline. As with an equal tax on products, an additional gasoline excise tax would be more competitively neutral than an oil import tax. An excise tax would not result in any particular advantage or disadvantage to any entity or sector of the oil industry. An excise tax would still permit independent marketers and chain retailers to capitalize on their functional efficiencies and thus serve as a downward influence on gasoline prices. Consumers also would continue to benefit from our efficiencies and competitiveness.

In sum, if an oil tax must be imposed, alternative measures such as an equal tax on imported and domestic petroleum products or an increase in the existing federal excise tax on gasoline would be preferable to an import tax because they do not disturb a level playing field in the petroleum business. Such measures would preserve the present competitively neutral conditions in the oil industry and would permit independent marketers to continue providing U.S. consumers with the benefits of their efficiencies.

Appendix A & B are in the official committee files.

Senator **Wallop**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

Just a comment on Mr. Bolch's statement. It is interesting to see what we are running into with so much managed trade in the world. Let's talk about refined products. Japan is one of the most competitive of societies. Yet, they very aggressively restrict importation of refined products. That is what we are up against. We are seeing a lot of that in Europe, too. And it is taking place today.

Mr. Phelps, I heard your comments about the tax situation. What we are seeing in the House tax bill is a limitation on the credit for utilization of the IDC's, and we are seeing a limitation put on at 65 percent of production income. I have had some of them tell me that what that means is a self-liquidating program, in effect.

Some of the independents have said, "well, that means that then I will get credit for 65 percent of my production income this year. And next year I will take 65 percent of the remainder. And finally I go out of the business." That is not what we should be trying to do.

Mr. **Phelps**. I do agree with you on that, Senator.

Senator **Bentsen**. And I recognize some of the problems, frankly. But, I think, the situation we face now is so difficult that I choose this as an avenue of accomplishing it. But I very much agree with you insofar as what the tax law being sent over by the House does.

Would you care to comment? Do you think that is a self-liquidating program if we followed that kind of a tax law?

Mr. **Phelps**. Very definitely. And, of course, there is also the 50 percent limitation on percentage depletion on each property. And those taken in combination certainly, I think, are very detrimental to expanding our reserve base and providing for some of these things that we all feel are important. And that is to be able to continue to produce oil in these United States.

Senator **Wallop**. And the minimum tax weighs in on top of that, doesn't it?

Senator **Bentsen**. Well, that is what I am hitting at—the alternative minimum coming in on the 65 percent. And there is where you are caught on that one.

Mr. Hunt, you have mentioned the various categories of domestic crude production that will be impaired if the price remains below $15 a barrel. Are there any other problems that will result in a significant loss of reduction?

Mr. **Hunt**. Well, Senator, I think at $15 a barrel for a sustained period of time, using my own company's experience, we have to cut where we can but because our cash-flow has been drastically affected by this drop in prices. Some wells, marginal wells, stripper wells—some are expensive to continue to operate. Some require as they go to water remedial work. And it is just not justified when you look at the economics of spending additional capital to continue the production of marginal wells. So you begin to shut in those wells.

You also find that there are many wells that you may have planned to drill but the economics just don't work out so you cut back your capital expenditures. Even some development wells are not done at that level, development drilling.

Senator **Bentsen**. I am pleased to see that my friend Mickey Smith, who is the mayor of Kilgore, TX, is here as head of the East Texas Producers & Royalty Owners. And I understand we have a statement submitted on his behalf for the record. Is that right?

Mr. **Hunt**. Yes, Senator.

Senator **Bentsen**. He is here in the audience. We are pleased to have him here.

Mr. Chairman, we have held these folks a long time, and I will not continue to question them.

Senator **Wallop**. We have, indeed. There are a couple of little areas that I wanted to explore.

Mr. Slocum, in your testimony you mentioned the prices of imports and the offers that people were having to back out natural gas and coal. Can you give us any kind of an idea of what price crude oil reaches before coal and gas? I assume they are different, and they no longer have an economic reality to them.

Mr. **Slocum**. Yes. Right now, we are seeing cargoes of fuel oil coming into particularly the east coast from Florida right up through New Jersey into Massachusetts in the $15 range. And as I say, week to week, it is coming down.

The equivalent gas price delivered to the burner tip is about $2.50. If you back that down to the wellhead, you are talking prices well below $2 at the wellhead. I think anybody that has been in the E&P business knows that you have to be a superexplorer over time to be able to find, develop, and get a satisfactory return on your investment at prices—hanging down at those levels.

Senator **Wallop**. That is at $15 barrel the equivalent is below $2 per thousand cubic feet at the wellhead?

Mr. **Slocum**. Right.

As far as coal is concerned, I believe it is pretty much in the same area. And I am told by friendly utility executives in Florida, for instance, that their coal—by wire—power sales are going down at the expense of increased fuel oil sales. Obviously, coal is our most abundant, lowest cost fuel for the long term, and to be kicking that industry now seems to be double jeopardy for the long pull.

Senator **Wallop**. One of the effects that came about in the economic gyrations of the last decade was this enormously expanded fuel-switching capacity. One of the arguments that no longer works but is always made by folks like Senator Metzenbaum is that the people with natural gas are captive and they cannot go change brands at the corner.

But a great many manufacturing facilities, a great many generating facilities, certainly can. And, therefore, that is one of the reasons why Senator Bentsen and I chose the word "survival" price. I was not sure and I am still not sure what that is. Dr. Singer says we came pretty close with $22.

There is an argument that can be made in a number of directions.

Mr. Jandacek, one of the other prices we chose, and not really with any expertise, was the $3 differential. Your testimony suggests that $2.32 is the more accurate number, but let me ask you if you recognize the U.S. Department of Commerce's report regarding pollution abatement cost and expenditures as reasonably authoritative. It is a 1983 report from the Department of Commerce.

Mr. **Jandacek.** I am not familiar with that report. Our data was taken from the API information where we—the information we have is that the industry has spent about $2½ billion a year in water and air pollution controls since 1980. We use that as a partial element in calculating this enviromental offset cost—$2.30.

Senator **Wallop.** Well, they are not altogether that far different.

Mr. **Jandacek.** No.

Senator **Wallop.** This is a little smaller. Page 40 of that document indicated in 1983 that refiners expended about $1.8 billion given a margin of cost-of-living increases. It is not too far out of that.

But it also goes on to say that they recovered approximately a half a billion in that year in saleable product. So would you agree with that generally?

Mr. **Jandacek.** I really do not—I mean as a result of those expenditures?

Senator **Wallop.** Yes. It says that in the process of pollution abatement, there was a recovery of saleable products in the terms of a half a billion.

Mr. **Jandacek.** In those expenditures that I am personally familiar with that we have made in our refining systems, with the exception of recovering some sulphur, I do not think that there is much in the way of other recoverable products. I think that is a small element in the overall equation.

Senator **Wallop.** There would have been about a fifth.

Mr. **Jandacek.** I tried to stress in my testimony, Senator, that we have tried to take the simplest possible approach to calculating these numbers. And we admit very freely that there are other ways.

Senator **Wallop.** What we would like to do is inquire from you and take a look at these figures because if they are generally incorrect, then one thing prevails. If they are generally correct, then another one does. But if they are generally correct, they would suggest that the amount of differential that appears to be able to be justified would be something closer to the neighborhood of $0.30 a barrel.

And I think that that is an argument somebody is going to make to us. And so we would just as well now have a response from you on that.

Mr. **Jandacek.** Well the two dollars and thirty odd cents that we have calculated includes also the cost disadvantages of the lead phased-on regulations in addition to the elements of water and air pollution.

Senator **Wallop.** Yes. But, presumably, that is the same cost to an imported barrel as it is to a——

Mr. **Jandacek.** No, sir. The foreign refiners have a distinct advantage in producing unleaded gasoline for—or leaded gasoline for that matter—for market in the United States.

Senator **Wallop.** Mr. Bolch, can you import leaded gasoline without restriction?

Mr. **Bolch.** Well, as I pointed out, less than 6 percent of our total gasoline needs is imported.

Senator **Wallop**. But that is not my question. Can you import leaded gasoline without restrictions?

Mr. **Bolch**. I believe so. Yes, sir.

Mr. **Jandacek**. What I am saying is in the cost of the manufacture of that gasoline, that the American U.S. refiners are disadvantaged significantly because of the slow pace of the lead phased on regulations in foreign countries.

Senator **Wallop**. Let me make an observation here. You are identifying some common areas and threads amongst the various people supporting this and opposing it. A general one seems to be that there should not be a a differential or an exemption for certain products like home heating oil and other things because of the competitive advantage that would provide to foreign products of the exempted category. That is all well and good, but it gives Senator Bentsen and me a more complicated problem because if we don't have some exemption in the New England area, which is not overjoyed with this prospect anyway, we will be even less so.

I hope those of you who have been witnesses this morning and afternoon have some indication of the complexity of the task that we face as we try to do something io the realm of energy policy that is responsible, taking into account a variety of tax policies and economic policies and other things. It is not going to be an easy road that we have launched on.

Mr. **Phelps**. I would add, Senator, if you counted up how many other exemptions other than New England fuel oil you are going to be asked to——

Senator **Wallop**. Yes. And I am concerned with that. Mr. Bolch and others touched on it. I don't think Senator Bentsen and I are any strangers to entitlement programs and a bunch of other things that complicated lives in the past. And some you have seen those who have introduced bills whose general purpose is revenue, bills which would exempt feedstocks and hemisphere oil and a variety of other things, and end out with essentially your gasoline tax, but that would have no energy policy consequences for us.

It is no easy deal.

Senator Bensten.

Senator **Bentsen**. I just wanted to make one comment about the fact that so many witnesses have testified about the hits the oil industry is taking and its problems right now. I was looking at this card I carry which tells me where I am supposed to be every 15 minutes. And on the back side it reminds me of who I am. [Laughter.]

But the next place I go is the Superfund conference. Senator Wallop and I once again are teamed up, trying to do something there about paying for cleaning up toxic waste. It is terribly important that we do clean them up and that we do that cleanup quickly. But how the petrochemical industry has been hit on that one. You are talking about over 70 percent of that tax certainly being paid by the petrochemical industry. And yet toxic waste is a societal problem. Chemicals are used across all manufacturing and all manufacturing contributes to toxic waste.

I can take you out to Silicon Valley to a so-called clean industry, high technology. Yet, there is one of the worst toxic waste sites in the United States there, the Stringfellow site. And not one of these petrochemical comanies contributed to any of that. But that is where they want the hit to be.

So Senator Wallop and I passed a bipartisan bill through this committee and through the Senate with a margin better than 2 to 1 on both sides of the aisle. It was designed to see that that fund is properly financed and that the burden for toxic clean up is shared by all manufacturing entities which contribute to it.

Senator WALLOP. Well, you members of the industry can at least go home and feel comforted by the fact that the Congress in its tax policies and environmental policies still views you as overpowering the prosperous. [Laughter.]

We will call this subcommittee adjourned for today, and we will reconvene tomorrow at 9.

[Whereupon, at 1:52 p.m., the hearing was recessed and scheduled to reconvene at 9 a.m., Friday, February 28, 1986.]

TAXATION OF IMPORTED OIL

FRIDAY, FEBRUARY 28, 1986

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
Washington, DC.

The committee convened, pursuant to recess, at 9 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman) presiding.

Present: Senators Chafee, Heinz, Wallop, Durenberger, Symms, Grassley, Long, Bentsen, Matsunaga, and Moynihan.

Senator WALLOP. Good morning. The subcommittee will come to order. Having had a very full and rather fascinating day yesterday, the committee resumes its examinations of the possibility that some form of oil import fee is in the interests of the United States.

We heard obviously very strong and conflicting testimony in opposite directions on that subject yesterday. Let me again say that, viewed from any perspective but energy policy, I think it is as irresponsible as many people thought it was for all reasons yesterday. If one constructs it in such a way as Senator Bentsen and I have, where it is pegged to a survival price—and that may be an arguable figure—it certainly is an arguable figure—it cannot be used for tax reform, and it cannot be used for deficit reduction because you cannot forecast the price that oil will remain over the course of the period of the tax.

When the world price of oil reaches the survival price, as it is called, the tax simply vanishes. When it falls below that, it exists. We tried, without success, to get the coal industry to focus on this because we had some testimony yesterday that shows the direct and distinct relationship between the economic viability of coal and the world price of oil. The same with natural gas and the same with all kinds of measures of conservation; and that is why it must be considered in the light of energy policy. It is my hope that we can at least focus on it from that perspective. There is, I think, general agreement on the committee that it is not good to do as the administration suggested: Use an oil import fee as a means of funding tax reform. It thereby becomes a matter of tax abuse in my opinion, used in that way. And likewise, I don't think it has much validity, given some of the problems that were identified by witnesses yesterday, as a revenue raiser.

It has validity as a matter of energy policy. It may or may not have such sufficient validity that it outweighs some of the detriments that were identified. And again, I would suggest that is the process in which we engage today.

We had yesterday a number of opening statements by members of the committee, but there were those who did not speak. Senator Heinz, did you have a statement?

Senator **Heinz**. Mr. Chairman, no. I want to be a witness.

Senator **Wallop**. Well, I am under way here. If you wish to be a witness, go be a witness. If you assume to make an opening statement, I assume the words will be the same.

Senator **Heinz**. I will do both right now.

Senator **Wallop**. All right.

Senator **Chafee**. Mr. Chairman, just before he starts, I notice you have me on the list there; and I did my statement and testimony yesterday. So, I will not be repeating today.

Senator **Wallop**. I appreciate that. Thank you.

STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator **Heinz**. Mr. Chairman, first of all, I want to thank you for holding these hearings on the oil import proposals that have been made. I am here to testify from the vantage point of the Northeast-Midwest Coalition; and of course, we strongly oppose taxing imported oil.

Senator **Wallop**. If you are more comfortable making your statement from this table, that is fine by me.

Senator **Heinz**. Yesterday this subcommittee heard testimony which, from my examination, make a convincing case that protecting the domestic oil industry with a tax on imported oil represented a harmful economic policy, a dangerous energy policy, and a totally inefficient source of revenue. In addition, according to the Consumer Federation of America, an oil tax is the most highly regressive form of tax, short of a tax on medical services. Because that case has already been made, I am going to focus my remarks this morning on how taxing imported oil would place an unfair and discriminatory cost on residents and businesses in the Northeast and Midwest, and provide a windfall for oil producers in the Southwest.

My views, Mr. Chairman, are partly framed from the perspective of my constituents in Pennsylvania in my State where residents would be among the oil consumers most severely hurt by a tax on imported oil, and my State is not unlike those States that comprise the Northeast and Midwest Coalition. In my State, an oil import fee raising $10 billion in revenue for the Federal Government would saddle Pennsylvania oil consumers with another $1.3 billion or more each year in energy bills. Let's think for a moment what that $1.3 billion from Pennsylvania consumers to producers would mean, Mr. Chairman. According to the administration, which testified yesterday, a $5 per barrel fee would increase energy costs for the average family earning $10,000 at least $125 per year. Now, that is the average family.

The average family in my State doesn't heat with oil. The average family heats with natural gas. Forty percent of the people in my State heat with oil. Gas prices are relatively stable. They are locked in by contract.

What that really means in my State and for the Nation as a whole is that the actual price increase to the average oil using consumer heating with oil is in the neighborhood of closer to $300 a year or more, for a family now earning $10,000 a year. In the face of the general cutback of support in student aid, in AFDC, in Medicaid, in other programs a $250 to $350 increase in heating bills for a relatively poor off family would be back-breaking and simply unconscionable. Pennsylvania is not the only State hurt. In the region, of course, oil is a primary energy source throughout the region, and it is of course the economic life blood of the region's manufacturing and agricultural activities. States in our region have been hit hard by the increased cost of energy since the first energy crisis of the 1970's, with average household energy bills one-third higher than for households in the Southwest.

According to a study by the Northeast-Midwest Institute, an oil import fee designed to raise $10 billion in revenue, that is a fee set at $5.80 a barrel, would create a windfall for domestic producers of over twice that amount, fully $21 billion. In other words, an oil import fee of this size would transfer $21 billion nationwide from American consumers to oil producers. Over two-thirds of that windfall would accrue to only four States: Alaska, Oklahoma, Texas, and Louisiana. Maybe that explains why there is strong support for this fee from Senators representing those States.

The decline in oil prices is the best news our economy has had in a long time. Almost daily now, various Government and business forecasts the economy's performance project encouraging statistics showing faster growth, lower inflation, and stable interest rates, all as a direct consequence of lower oil prices. And yesterday, when the market went through the 1,700 level as if it wasn't there, a considerable amount of the speculation was falling oil prices made it happen.

Now, I might add that according to the consumer federation every job lost in the oil industry as a result of falling prices results in the creation of six jobs in other sectors of the conomy. Mr. Chairman, the people and industries of my region of the country—the Northeast and Midwest—were hurt by the 1973 OPEC cartel oil price increase, pummeled by the 1979 oil price runup, and devastated by the 1982 recession. Indeed it is only just now beginning to emerge from that recession. While I can sympathize with the damage that falling oil prices could do to the industry, I think that a solution which involves penalizing virtually every other area of the country, which has already been penalized by the artificial oil price runup of the last 10 to 12 years, is in fact irrational; nor do I think it is fair to ask one region of the country to suffer in order to benefit another.

There are things we can do to help the oil industry, and it is a vitally important industry; but I will adamantly oppose as will the members of the Northeast and Midwest Coalition any effort to pursue the shortsighted, inequitable and economically irresponsible policy that an oil import fee represents.

Let me conclude, Mr. Chairman, on this note. I can well remember in the 1970's when oil producers fought against Government policies which artificially held down prices at a time when they were soaring. At that time, the battle cry was "let the free market work." If I heard it once, I heard it a hundred times, from House and Senate members, oil producing States: Decontrol oil, decontrol gas; let the free market work. I find it ironic, to say the least, that the same people who said "let the free market work" are now urging Government protection against the forces of the free market, forces which are now pushing down artificially high cartel-set oil prices. It seems to me, Mr. Chairman, that an oil import tax is nothing short of "recontrol" of the price of oil. Thank you.

Senator Wallop. Thank you, Senator Heinz. I want to point out to you, as I did to others yesterday, that we appreciate your understanding of the troubles of the industry and other things we can do for it. If you are worried about taxes adding to your consumer's bill, then I assume you would join us in the removal of the windfall profits tax, which has taken $77 billion out of those very consumers' pockets.

Senator Heinz. There are circumstances, Mr. Chairman, under which I could be persuaded to make some changes there. Yes, but I am not going to endorse a blanket repeal of that, either; and I think you are wise enough to know that I am not going to.

Senator Wallop. I am wise enough to know that. I am also wise enough to know that this fairness doctrine has a rather limited application.

Senator Heinz. The fairness doctrine, today, Mr. Chairman I don't think is at issue. What is at issue is whether we should impose a $5, $6, or $10 per barrel tax to prop up oil producers and their banks. And basically, we are propping them up in this country.

Senator Wallop. Yes, that is a misunderstanding of a bill that Senator Bentsen and I introduced to say it is a $5, $6, or $10 fee. It is no particular dollar figure.

Senator Heinz. It is a price prop.

Senator Wallop. Yes, it is indeed; and it has not only to do with the oil and gas industry but the entire energy complex of the United States which includes coal, important to your State, because there is a point below which the price of oil drops and your coal miners are totally out of work.

There is a point below which oil drops and none of the conservation measures that we benefitted so much from have any further value. Co-generation it out the window. Then, any technological advances in coal are out the window. So, an import fee is worthy of examination and not worthy of scorn. It may not be the right thing to do, and that is the purpose of the hearings; but it is not worthy of scorn if you view it from the perspective of energy policy.

Senator Heinz. Mr. Chairman, I am not scorning it. I am disagreeing with it. I am opposing it. I have given my reasons for opposing it; but I don't scorn the proposal.

If I might, I would like to make one observation which is that there have been many proposals over the years to protect many industries. The oil import fee is an import tariff of a considerable extent. It is about—if it were to be resolved, it would be returning the price of oil to $25 a barrel——

Senator Wallop. That has not been suggested.

Senator HEINZ. I said if it were—to resolve it in fact—it would be the equivalent of present oil prices of about a 66⅔ percent tariff on imported oil; and that is pretty steep.

Senator WALLOP. It would be, but inasmuch as nobody is suggesting that, that is an abstraction that isn't in front of the committee.

Senator HEINZ. Well, there is legislation that has been introduced and is pending before the Finance Committee, Mr. Chairman, that would do that. I refer to Senator Boren's proposal. I assume that we are not just holding hearings on one specific proposal in the abstract, or in particular.

I thought that we were looking at a variety of proposals that have been submitted to the committee and particularly those by very influential advocates on the committee, whether they be yourself, Mr. Chairman—and you are influential or a good advocate—and Senator Boren, Senator Bentsen, and others.

Senator WALLOP. Well, I don't quarrel with that. [Laughter.]

But I would invite you and other members of the Congress to take advantage of the time to examine energy policy in America. When it was going up, you and others were full of revenge—had no time to——

Senator HEINZ. I was full of revenge, Mr. Chairman?

Senator WALLOP. Yes, sir. You were one of those who were one of the great advocates of the windfall profits tax, looking at the profits the industry is making, and one thing and another——

Senator HEINZ. Mr. Chairman, let's not rewrite history. We were faced with a question of how we brought about the orderly decontrol of oil. I don't want to have my position characterized by any member of this body; and I haven't characterized your motives at any point in time. I have not characterized anything you are saying as vengeful, revengeful; and I don't think you need to characterize my position as——

Senator WALLOP. I was generally characterizing Congress. Generally, Congress is not examining energy in——

Senator HEINZ. Mr. Chairman, I don't want to be contentious, but I felt that it was necessary in order to bring about the decontrol of oil prices to have a windfall profits tax. There were a lot of votes I cast to try and bring about a sensible resolution of that tax. And if we had not had it, Mr. Chairman, the price of oil—of old oil—would never have been decontrolled. I thought that was the right policy.

Senator WALLOP. Those events were scarcely simultaneous. The windfall profits tax came about when nobody was talking decontrol; and it came about at a time when prices were rising and were meant to control and to reap a little of that to the Treasury of the United States. And as I pointed out, it did come from the pockets of the very consumers whom we now feel——

Senator HEINZ. Mr. Chairman, I really don't want to get into an argument about that, but the President said that he would not sign legislation about the decontrol of oil unless there was a windfall profits tax, and so on and so forth. I don't quite know what this has to do with the issue that is before us now.

Senator WALLOP. Very well. Senator Moynihan?

[The prepared written statement of Senator Heinz follows:]

STATEMENT BY

UNITED STATES SENATOR JOHN HEINZ

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

28 FEBRUARY 1986

Good morning Mr. Chairman and thank you for providing this opportunity for me to testify on behalf of the Northeast-Midwest Senate Coalition regarding proposals to tax imported oil.

Yesterday, this Subcommittee heard testimony which, from my examination, made a convincing case that protecting the domestic oil industry with a tax on imported oil represented a harmful economic policy, a dangerous energy policy, and a totally inefficient source of revenue. In addition, according to the Consumer Federation of America, an oil tax is the most highly regressive form of tax short of a tax on medical services. Because that case has already been made, I will focus my remarks this morning on how taxing imported oil would place an unfair and discriminatory cost on residents and businesses in the Northeast and Midwest, and provide a windfall for oil producers in the Southwest.

Of course, my views are framed from the perspective of Pennsylvania where residents and factories would be among the oil consumers most severely hurt by a tax on imported oil. An oil import fee raising $10 billion in revenue would saddle Pennsylvania oil consumers with another $1.3 billion or more each year in energy bills.

Let's think about what it means to transfer $1.3 billion from consumers to producers Mr. Chairman. According to the Treasury Department, a $5 per barrel fee would result in increased energy costs of $125 to families with annual incomes of $10,000 or less. In the face of federal cutbacks in Medicaid, AFDC and other programs, I think imposing a $125 a year burden in the form of an oil tax is just unconscionable.

Pennsylvania is only one of the states in the Northeast and Midwest region that would be hurt by a tax on imported oil. Oil is the primary energy source for the entire Northeast-Midwest region and the economic lifeblood for most of the region's manufacturing and agricultural activities. States in our region have been hit hard by the increased cost of energy since the first energy crises of the 1970s, with average household energy bills one-third higher than for households in the South and West.

According to a study by the Northeast-Midwest Institute, an oil import fee designed to raise $10 billion in revenue, that is, a fee set at

$5.80 per barrel, would create a windfall for domestic producers of over twice that amount--fully $21 billion. In other words, an oil import fee of this size would transfer $21 billion from oil consumers to oil producers.

Over two-thirds of this windfall would accrue to only four states: Alaska, Oklahoma, Texas and Louisiana. In total, more than $11 billion would flow each year from the Northeast and Midwest to the South and West.

The decline in oil prices is the best news our economy has had in a long time. Almost daily now, various government and business forecasts of the economy's performance project encouraging statistics showing faster growth, lower inflation, and stable interest rates--all as a direct consequence of lower oil prices. Indeed, according to the Consumer Federation of America, every job lost in the oil industry as a result of falling prices results in the creation of six jobs in other sectors of the economy.

Mr. Chairman, my region of the country was devastated in the 1982 recession. Indeed, it is only just beginning to emerge from that recession. While I can sympathize with the damage that falling oil prices could do to the oil industry, I do not think a solution which involves penalizing virtually every other industry, from chemicals to steel, makes sense. Nor do I think it is fair to ask one region of the country to suffer in order to benefit another. There are things we can do to help the oil industry--and it is a vitally important industry--but I will adamantly oppose any effort to pursue the shortsighted, inequitable and economically irresponsible policy that an oil import fee represents.

I will conclude on this note Mr. Chairman. I can remember well in the 1970s when oil producers fought against government policies which artificially held down oil prices at a time when they were soaring. At that time, the battle cry was "let the free market work." I find it ironic that the same people are urging government protection against the forces of the free market which are now pushing oil prices down. It seems to me, Mr. Chairman, that an oil import tax is really nothing short of oil "recontrol."

Again, I thank you, Mr. Chairman, and the other members of this Subcommittee for this opportunity to demonstrate the regional unfairness of an oil import tax.

NORTHEAST-MIDWEST SENATE COALITION
NORTHEAST-MIDWEST CONGRESSIONAL COALITION
NORTHEAST-MIDWEST INSTITUTE

STATE-BY-STATE CONSUMER IMPACT OF $10 BILLION OIL IMPORT FEE
(in millions of dollars)

Region and State	Producers' Windfall	Consumer Impact[1]
New England		
Connecticut	0	478
Maine	0	254
Massachusetts	0	809
New Hampshire	0	123
Rhode Island	0	98
Vermont	0	60
Mid-Atlantic		
Delaware	0	117
Maryland	0	509
New Jersey	0	1,277
New York	6	1,781
Pennsylvania	28	1,293
Midwest		
Illinois	190	1,243
Indiana	36	683
Iowa	0	384
Michigan	201	707
Minnesota	0	534
Missouri	2	600
Ohio	101	1,276
Wisconsin	0	482
South		
Alabama	130	486
Arkansas	123	314
District of Columbia	0	47
Florida	95	1,530
Georgia	0	730
Kentucky	51	451
Louisiana	3,394	1,476
Mississippi	216	339
North Carolina	0	678
Oklahoma	1,109	479
South Carolina	0	335
Tennessee	6	503
Texas	5,959	3,815
Virginia	0	651
West Virginia	23	195

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West		
Alaska	4,152	168
Arizona	1	317
California	2,714	2,905
Colorado	190	347
Hawaii	0	237
Idaho	0	112
Kansas	499	362
Montana	196	140
Nebraska	42	211
Nevada	13	139
New Mexico	523	212
North Dakota	347	141
Oregon	0	356
South Dakota	9	112
Utah	228	184
Washington	0	554
Wyoming	818	170
U.S. Total	21,403	31,403

*All state figures based on 1983 percentages. The ratio of petroleum imports to total petroleum consumption is based on 1984 data.

[1] Averages $5.81 barrel on petroleum imports. Assumes domestically produced oil price equals import price and averages 14.3 cents/gallon fuel oil and 12.6 cents/gallon gasoline. Although the price of oil affects the price of natural gas and coal as well, it is not possible to quantify the impact.

SOURCE: Northeast-Midwest Institute staff calculations based on data from U.S. Department of Energy, Energy Information Administration.

Senator **Moynihan**. Mr. Chairman, thank you. I see that we have a most distinguished group of guests from the House, Representatives Schneider, Jones, and Conte, and our own Senator Caliborne Pell. So, although I am on the witness list, perhaps I might put in my statement in the record and just summarize it; and then we can argue about the windfall profits tax again. [Laughter.]

Senator **Moynihan**. Mr. Chairman, if I had one service I might render this whole inquiry it is on the subject of semantic infiltration, which is a technique nations use when they negotiate. If you can get the other side to start using your words to describe a particular reality, you have already won half the case.

And an oil import fee sounds like something they charge for testing for purity or alcoholic content or somehow verifying quality. What we are talking about is an oil tariff, as Senator Heinz very correctly stated. An oil tariff or a tariff of any kind has the purpose of raising the price internally of a particular product, whether it be produced internally or not. And this is a tariff, and it can be predicted to have one event which is to raise costs for domestic manufacturers; and to the extent that they are in export industries, they are certainly going to be at less of an advantage in overseas markets than their overseas competitors for the simple reason that their costs will be relatively greater. With respect to their domestic markets, you can make some forecast that American consumers will choose products that are made overseas and imported for the simple reason that they will be cheaper due to the cheaper cost of oil that goes into their production; and there is almost no product that is not in some measure produced by oil.

We have some estimates on this. The Consumers Federation—Senator Heinz mentioned it—comes out with a suggestion that a $10 tariff would increase oil costs by $25 billion, which is a suspiciously round figure; but I suppose it could be quoted. It will lead to a one to two percent rise in inflation and a GNP reduction of $50 billion and a job loss of half a million, all of which are very round figures, which is just due to a hurried calculation; but it will be some increase in inflation and some loss in jobs. That can be predicted. Clearly, an oil import fee will have a different impact in parts of the country relating to geographical terms. Senator Heinz mentioned that; there would be four States that would get two-thirds of the tariff advantage, in terms of increased domestic prices and a number of States—New England exclusively—would be at a disadvantage. Few seem to realize that New York State is an oil producer. We started discovering oil in 1853. Unfortunately, we stopped in 1855, but there was a moment there.

Senator **Heinz**. Pennsylvanians really discovered oil first.

It way your oil we discovered. [Laughter.]

Senator **Moynihan**. It comes right across the Southern tier there, as you know.

Senator **Heinz**. There is a lot of revisionist history taking place here.

Senator **Moynihan**. I think there is a case to be made—I don't know how strong a case—that a tariff on imported oil is a kind of drain America first proposition. That case can be made. I think this might be, in happier fiscal terms, just the time to fill up our strategic reserve. I believe that is something the chairman has thought a lot about.

I would like to make two quick suggestions. The first is that almost certainly a gasoline tax is a better alternative simply because it does not appreciably raise manufacturing costs and it is geographically distributed much better, but not perfectly. The impact in Wyoming has got to be greater than the impact in Rhode Island or New York. We know that. It is just distances and densities and modes of transportation. Still, the automobile is pretty universal, and its use is pretty universal; and the gasoline tax would much less of the tariff type of consequences than a tariff on oil.

Finally, Mr. Chairman, I would like to suggest that if we really wanted to move towards this direction as a matter of revenue, we really ought to consider a general energy tax, simply a BTU-based tax, leaving aside coal and hydropower, which I think we have in such quantities that there would be a case against levying an energy tax there. But if we were to levy a tax on oil consumption, on uranium consumption, on natural gas consumption, a very light tax for which the collection mechanisms are already in place could produce considerable revenue and do so very equitably, particularly if it was rebated for purposes of residential heating.

I don't think the committee is going to be interested in something that ambitious; on the other hand, I do say that I have great respect for our chairman's concern about market forces. No matter how equitably you pick one source of energy, you start distorting the market because, in the end, what energy does produce is British thermal units; and they are themselves identical. And if you make the cost of that BTU from one source higher than for another source, you have artificial effects in the market.

And I think if we are raising revenue, we certainly ought to raise revenue with as little market distortion as possible. And I do assume that the purpose for which we are talking about an oil import tax for purposes of revenue and is not for purposes of giving advantages to one section of the economy over the other; but then, I don't know and I perhaps should not speak beyond my knowledge. And I thank you for your kind attention.

Senator WALLOP. Thank you, Senator Moynihan. We have suggested that, given the exigencies of Friday, we would go to members of——

Senator MOYNIHAN. Oh, no, I thought we were going to argue about the Windfall Profit Tax for just a little bit. [Laughter.]

Senator WALLOP. We are, but you and I are going down and we will do that over lunch. [Laughter.]

Senator CHAFEE. I don't think we want to get into waving the red flag in front of the bull here, Senator Moynihan. Let's get on with the hearing. [Laughter.]

Senator WALLOP. We have decided to recognize members of Congress as they came; so with that, I recognize Representative Schneider.

[The prepared written statement of Senator Moynihan follows:]

STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN

Mr. Chairman: I very much appreciate the opportunity to appear here today to present my thoughts on the taxation of imported oil -- a subject which has received much attention of late -- and, more broadly, the taxation of energy.

Foremost among my objections to an oil import fee is the effect such a tariff -- and let us not delude ourselves, this is most certainly a protectionist tariff -- would have on American firms attempting to compete here and abroad. Indeed, the effect is all too predictable. Oil is used, to some lesser or greater degree, in the production of almost every good and service. To tax imported oil, then, is to condemn domestic manufacturers to higher costs than are borne by their foreign competitors. In the end, American firms will find it more difficult to sell their goods both overseas and at home. The laws of economics tell us most clearly that the American consumer will seek to purchase cheaper, untaxed foreign oil in whatever form he can. If he cannot buy it directly, he will buy it as a component of cheaper foreign goods -- automobiles, steel and the like. The proposition, then, is simple: Unless we are prepared to protect every American industry that relies on oil, we had better not begin down that road by taxing imported oil.

Moreover, a tax on imported oil will not only impair the competitiveness of American industries, but will also hinder overall economic growth. This Committee has been bombarded over the past year with countless econometric predictions of the likely effects of removing one or another tax subsidy. Well, let's see what the numbers say about an oil import tax. According to the Consumer Federation of America, a $10 import fee would increase oil costs by $25 billion in its first year. This in turn will lead to a 1 to 2 percent rise in inflation, a reduction in the Gross National Product of $50 billion and a loss of 500,000 jobs.

An oil import fee is, without doubt, the most inefficient type of energy tax imaginable. For every dollar raised for the Treasury, a two dollar windfall would accrue to domestic producers of oil. This is bad tax policy and, to my mind, totally unacceptable.

An oil import fee is also among the most geographically inequitable forms of energy taxation. We use many different types of energy in this country -- coal, hydropower, natural gas, nuclear and oil. A tax on only one type of energy, then, disproportionately punishes those who, for one reason or another, heavily rely on that form of energy. In this case, tax oil and you punish the northeast. Nationally, oil accounts for roughly 40 percent of total energy consumption. In Rhode Island, 70 percent; New York, 52 percent.

A tax on imported oil is moreover a serious threat to this Nation's long-term energy security, for it encourages more rapid depletion of domestic reserves. "Drain America First." To my way of thinking, this is precisely what we should not be doing. The price will increase again -- maybe in a year, maybe in five years. Perhaps we should consider increasing strategic reserves while oil is plentiful. I am not unsympathetic to the plight of domestic oil producers. They are facing hard times. But an oil import tax is not the answer.

The best energy tax -- and I am not at all sure that any energy tax is a good idea right now -- would be a gasoline tax. No tax affects all regions equally, but a gasoline tax falls more equitably across the nation -- no region would be forced to bear the kind of burden that an oil tariff would impose on the northeast. A gas tax would not raise U.S. manufacturing costs, and our ability to compete in world markets would be unaffected. And such a tax would be far more efficient than an oil tariff: A $5/barrel tariff would collect some $10 billion, and raise the cost of all petroleum -- including gasoline -- $0.12/gallon. A $.10/gallon tax on gasoline alone would raise the same amount. And make vastly more sense.

If we were to enact an energy tax, this is the one we should do. But the political difficulty of adding substantial new gasoline taxes makes me doubt that we could do it. The next best choice is a broadly based energy tax, and that is what I shall propose.

Rather than taxing only imported oil, we should tax all oil, all natural gas and all energy from uranium. Let us leave coal and hydropower aside; these are resources that we can be less concerned about. And let us exempt from this tax all residential energy use -- consumers, particularly low-income consumers, will be faced with demands enough in the years to come. They should not pay a tax to heat or cool their homes.

Were we to tax imported oil alone, but 15 percent of the nation's energy use would be taxed, although energy prices would rise across-the-board. A relatively high rate would be required to raise substantial revenue. In my proposal, more than 2/3 of domestic energy would be taxable. Even after broad rebates to exempt all residential energy use, the burden of raising the desired revenue would be spread over half the nation's energy use. Rates 1/3 as high as those suggested for oil tariffs would raise the same amount of revenue, and do so more equitably. The cost of a gallon of gasoline might rise $.04 rather than $.12. And the price of oil, gas or electricity used to heat our homes would not rise at all.

I have substantial reservations about any energy tax. To use such a regressive tax to finance the preservation of loopholes in the income tax would be entirely unacceptable. So too an oil tariff -- protectionism for part of the domestic oil industry in the guise of a revenue measure. But a serious effort to raise revenues with an energy tax would be worth considering. A gasoline tax would be worth a try, and a well-crafted broad-based energy tax also could work well.

STATEMENT OF HON. CLAUDINE SCHNEIDER, A U.S. REPRESENTATIVE FROM THE STATE OF RHODE ISLAND

Congresswoman SCHNEIDER. Thank you, Mr. Chairman. My comments will reflect somewhat Senator Heinz' comments in looking at the microimpact of an oil import tax, but I would like to expand it and incorporate the macroimpact of an oil import tax. And also, I think Senator Moynihan made some very important points which also underline the theme of my comments having to do with equity in looking at the various options that we have.

I am very, very strongly opposed to an oil import fee that is reflected in both Senate bills S. 1507 and S. 1997. The oil import tax appears to be the most unfair and most inequitable revenue raiser that is being discussed. Even among energy taxes, there is a fundamental question of which would be the most fair to all regions of the country, as was already indicated. I think, first of all, if Congress believes that an energy tax of any sort is necessary, a less regressive gasoline tax or an across-the-board BTU tax would be much more equitable. The oil import tax takes disproportionate aim at the Frost Belt; and as an officer of the Northeast-Midwest Coalition, I can assure you that we are most anxious to see the report that I have requested from the Congressional Research Service which will evaluate the various energy taxes and their impact on the consumers and on the economy overall. I believe that a thorough analysis of this type is absolutely essential before any kind of legislation is undertaken.

I think we do have at our disposal now a number of studies which reflect the impact of the current dramatic drop in oil prices and the potential impact of an oil import tax. I would just like to list for you a number of these studies which indicate what has been going on overall with the recent drop in oil prices.

The Energy Information Administration put forth a study that said that if oil stabilizes at $18 a barrel for over a year, it would reduce the national oil bill by $46 billion. This savings would translate into an additional drop in inflation by 1 percent, a growth in the economy by 1 percent, and a 2 percent increase in industrial production.

Another study was done by the U.S. Chamber of Commerce which said that this economic growth would create 1 million new jobs. Additionally, consumers in a region like New England where 30 percent of our electricity is generated by oil, as compared to 5 percent nationwide, we would realize considerable savings for consumers.

A third study that has been done is the Farm Bureau Research Association which indicates that lower oil prices put farmers into a win/win situation by substantially reducing the cost of fertilizers and pesticides; which cost farmers about $14 billion last year.

The Polyeconomic Analysis concludes that, since oil is sold in terms of dollars—petrodollars—the lower world demand for oil will translate into lower demand for dollars. This will decrease the dollar's value against other major currencies and, as a result, U.S. exports will increase, thereby reducing the U.S. trade deficit—an important point I believe when we are looking at the whole macropicture of our energy policy.

And finally, the study by the U.S. Department of Economic Affairs reports that the decline in energy costs will lower the consumer price index as a result in the decline of wage increases and Government cost of living allowances. The indirect savings are estimated to be half of what the direct savings are.

Mr. Chairman, an oil import fee would negate many of these very positive benefits of the oil price reduction. According to a Federal Reserve Board of Dallas study, the deleterious side effects of rising inflation, unemployment, and declining economic growth could have a substantial impact on our economy overall. Economists have noted that an oil import tax will fall most heavily not on OPEC, as is the usual assumption, from whom we get less than 9 percent of our oil, but it will fall on our friendly neighbors, our debtors, and our allies; 56 percent of our oil comes from Mexico, Venezuela, Canada, and the United Kingdom, most of whom are in the weakest position relative to the OPEC producers to deal with an oil fee on top of a real price collapse. So, if the goal of the proposed import fee is to secure funds for reducing the deficit, there are far less regressive means—be they a gasoline tax or a BTU tax.

What I would like to know is: Why does the Senate and the House feel that we need to limit our vision to only energy taxes when we have a very creative opportunity before us? If we must, in fact, raise revenue—and it is something that I personally have not conceded as yet—I think that we have options other than energy taxes. Considering the recent drop in oil prices, the elimination of conservation tax credits, and the slashing of our R&D energy budget, I maintain that we have right now no clear, comprehensive energy policy that can securely lead us into the future. I don't believe that there is one person in this Congress or in the administration who has the pulse of the ramifications that these tax policies—energy tax policy decisions—might have on our energy future. I maintain that if we need to raise revenue, we should listen to the conventional wisdom of the people. According to public opinion polls, Americans overwhelmingly favor an increase in tax on tobacco and alcohol.

Citizens, along with this Member of Congress, cannot justify the expenditure of hard-earned tax dollars for tobacco subsidies on the one hand and cancer research and health care support on the other. According to research reports, $30 billion a year in tobacco sales incurs an additional $30 to $100 billion in health costs and the loss of economic productivity. An increased tobacco tax would account for some of these external costs with the secondary benefit of diminishing one-fifth of all American deaths each year.

In conclusion, while I can sincerely sympathize with the severe impact the oil price collapse is having on oil-producing States, I hope you will appreciate that oil-consuming States like my own and Senator Heinz' and Senator Moynihan's, that we have been similarly ravaged for more than a decade because of oil price hikes. A steady stream of business failures, bankruptcies and nagging unemployment attest to the hard times we have suffered; and we really don't care to relive these again in the form of an oil import tax.

So, Mr. Chairman, if we conclude that we really do, in fact, need to raise revenue, I implore you that we not act hastily or inequita-

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bly. Tax decisions will have a long-term impact. I suggest that we not be so speedy to tamper with our ill-defined and poorly understood energy policy. Long-term energy and resource planning should be part of our holistic goal. Let us be determined in our deficit reduction efforts and creative in our revenue enhancements. To this more equitable and reasoned end, I will be your ally. Thank you very much.

Senator **Wallop**. Thank you, Representative Schneider. Let me suggest that you have no quarrel from me that this is not a good means of raising revenue nor was our bill designed particularly in that way. It cannot really be viewed as that in its consequence.

Representative Conte?

[The prepared written statement of Congresswoman Schneider follows:]

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Testimony by Representative Claudine Schneider (R-RI)
Regarding Oil Import Fee Legislation
before the
Senate Subcommittee on Energy & Agricultural Taxation

February 28, 1986

Mr. Chairman,

I would like to express my strong opposition to the oil import fees proposed in Senate bills S. 1507 and S. 1997. I am opposed for several reasons which I will subsequently outline for you, but the overriding reason is that the oil import tax appears to be the most unfair and inequitable revenue raiser being discussed.

Even among energy taxes, there is a fundamental question of which would be most fair to all regions of the country. First of all, if Congress believes that an energy tax of some type is necessary, a far less regressive gasoline excise tax or an across-the-board BTU tax would be much more equitable. The oil import tax takes disproportionate aim at the Frostbelt.

I and the other Executive Officers of the Northeast-Midwest Coalition have asked the Congressional Research Service to evaluate the various energy taxes and their impact upon consumers and the economy as a whole. I believe that a thorough analysis of this sort is absolutely essential before any legislative action is undertaken.

We do, however, have at our disposal now a number of studies which reflect the impact of the recent dramatic drop in oil prices and the potential impact of an oil import tax:

* The Energy Information Administration indicates that if oil stabilizes at $18 per barrel for over a year, it would reduce the national oil bill by $46 billion. These savings would mean:
    - an additional drop in inflation by one percent.
    - growth in the economy of one percent.
    - a two percent increase in industrial production.

* According to the U.S. Chamber of Commerce, this economic growth would create one million new jobs. Additionally, consumers in a region like New England, where 30 percent of our electricity is generated by oil (as compared to five percent nationwide), would realize considerable savings.

* The Farm Bureau Research Association indicates that lower oil prices put farmers into a "win-win" situation by substantially reducing the cost of fertilizers and pesticides, which amounted to $14 billion last year.

* The Polyconomics analysis concludes that since oil is sold in terms of dollars -- petrodollars -lower world demand for oil will translate into lower demand for dollars. This will decrease the dollar's value against other major currencies. As a result, U.S. exports will increase, thereby reducing the U.S. trade deficit.

* The U.S. Department of Economic Affairs reports that the decline in energy cost will lower the Consumer Price Index as a result of a decline in the rate of wage increase and government cost-of-living allowances. Indirect savings are estimated to be half the direct savings.

Mr. Chairman, an oil import fee would negate many of these positive benefits of the oil price reduction. The Federal Reserve Bank reported that an import fee could have deleterious side-effects including rising inflation, unemployment and declining economic growth.

Economists have also noted that an oil tax would fall most heavily not on OPEC (from whom we get less than nine percent of our oil) but on our friendly neighbors, debtors and allies — 56 percent from Mexico, Venezuela, Canada and the United Kingdom — most of whom are in the weakest position (relative to OPEC producers) to deal with an oil fee on top of a real price collapse.

If the goal of the proposed import fee is to secure funds for reducing the deficit, there are far less regressive means, be they a gasoline tax or a BTU tax. I must ask why the Congress is limiting our mission to energy when we have a creative opportunity to raise revenue. If we must, in fact, raise revenue — something that I personally have not conceded — we have options other than energy taxes.

Considering the recent drop in oil prices, elimination of conservation tax credits, and the slashing of the R & D energy budget, I maintain that we have no clear, comprehensive energy policy that can securely lead us into the future. Not one person in this Congress or in the Administration has the pulse of the ramifications these tax policy decisions will have on our energy future.

I maintain that if we need to raise revenue, we should listen to the conventional wisdom of the people. According to public opinion polls, Americans overwhelmingly favor an increased tax on tobacco and alcohol.

Citizens, along with this Member of Congress, cannot justify the expenditure of hard-earned tax dollars for tobacco subsidies on the one hand, and cancer research and health care support on the other. According to research reports, $30 billion a year in tobacco sales incurs an additional $30 to $100 billion in health costs and loss of economic productivity. An increased tobacco tax would account for these external costs, with a secondary benefit of diminishing one-fifth of all American deaths each year.

In conclusion, while I can sincerely sympathize with the severe impact that the oil price collapse is having on oil-producing states, I hope you will appreciate that oil-consuming states like my own have been similarly ravaged for more than a decade because of oil price hikes. A steady stream of business failures, bankruptcies and nagging unemployment attest to the hard times we've suffered. We do not want to relive these again in the form of an oil import tax.

Mr. Chairman, if we must raise revenue, I implore you that we not act hastily or inequitably. Tax decisions will have a long term impact. I suggest that we not be so speedy to tamper with our ill-defined and poorly understood energy policy. Long term energy and resource planning should be part of our goal. Let us be determined in our deficit reduction efforts and creative in our revenue enhancements. To this end, I will be your ally. Thank you.

STATEMENT OF HON. SILVIO O. CONTE, A U.S. REPRESENTATIVE FROM THE STATE OF MASSACHUSETTS

Congressman CONTE. Thank you, Mr. Chairman and members of the committee, for allowing me to testify here today.

For the past three Congresses, I have authored a resolution expressing the sense of the House that an oil import fee should not be enacted, and I oppose that concept strongly. Oil import fees have been suggested many times over the past two decades, and they have been suggested as a cure for everything but for the common cold. We are told that consumers and the economy can afford the fee because oil prices are falling; that oil import fees are a painless way to raise necessary revenue, either for deficit reduction or to pay for tax breaks as part of tax reform.

Congress must reduce the deficit, but the issue is how. I have long advocated a combination of a reasonable, fair spending restraint in all areas of the budget and, of course, new revenues. But by new revenues, I do not mean an unfair, regressive tax like an oil import fee. If we are serious about raising revenue, we should close the loopholes in the tax laws. A true, effective minimum tax—unlike the one we have now—would be a first start.

An even more preposterous suggestion is to use the revenue from an oil import fee to pay for more loophole openings as part of tax reform. I can't conceive of a more unfair, inequitable, and unreasonable suggestion. Effectively, Congress would pay for a tax break for the rich by imposing a harsh tax on the poor. It just doesn't make sense.

People say that an oil import fee would be harmless because of falling oil prices. Nothing could be further from the truth. The economic implications of an oil import fee are higher prices, higher unemployment, and slow or negative growth in the gross national product. An oil import fee would take money out of the economy and slow growth, which, in turn, would increase the deficit.

There are, however, long-term benefits of falling oil prices. Those benefits are showing up in the economy right now and will continue if Congress doesn't resort to the short-sighted, unfair solution of oil import fees. Using economic terms, lower oil prices shift the aggregate supply curve out, resulting in lower prices and higher levels of GNP. Using much simpler terms, it is like the man who keeps hitting himself in the head with a hammer. He feels good when it stops. Well, our economy has been hit on the head with rising oil prices for many years; and it feels great now that it has stooped. Why hit ourselves in the head again?

Economic models indicate that just $5 a barrel drop in oil prices translates to 0.5 percent increase in the GNP, which in turn reduces the budget deficit by $20 billion. The inflation rate could fall by 1 percent. Unemployment could fall by 0.4 percent. Falling oil prices create very clear benefits. But a $5 per barrel oil import fee would increase costs to the consumer by $35 billion. Domestic oil producers would raise their prices. In all, such a fee would only raise $6 to $7 billion for the Federal Government.

An oil import fee is also regionally unfair because its primary effects will be felt in the Northeast and Midwest where 80 percent of home heating oil is imported.

Mr. Chairman, for every complex problem, there is an easy answer. It is short, simple, and wrong. An oil import fee is a classic example. I urge you not to make the tragic mistake of imposing an oil import fee.

Senator **Wallop**. Thank you, Representative Conte.

Representative Jones?

[The prepared written statement of Congressman Conte follows:]

REMARKS OF THE HONORABLE SILVIO O. CONTE BEFORE THE SENATE FINANCE COMMITTEE ON OIL IMPORT FEES

Mr. Chairman and members of the Committee, I want to thank you for providing me the opportunity to testify at today's hearings on the subject of oil import fees. As everyone in this room knows, this is an enormously controversial issue, and I appreciate the opportunity to be here.

Mr. Chairman, I am strongly opposed to proposals to impose any sort of oil import fee. For the past three Congresses, I have authored a resolution expressing the sense of the House that an oil import fee should not be enacted. I will keep my spoken remarks short today, and ask unanimous consent that I be allowed to submit a longer statement for the record of today's hearings.

BACKGROUND ON OIL IMPORT FEES

Oil import fees have been proposed many times over the past two decades. They've been suggested as a cure for everything but the common cold. They're supposed to reduce our dependence on foreign oil, raise revenue, and conserve energy.

Although the reasons for imposing a fee often change, the arguments do not. We're told that the American consumer and economy can afford the fees because oil prices are falling. We're told that stable energy prices conserve energy. Even now, we're told that oil import fees are a painless way to raise necessary revenue.

There are two fundamental suggestions for use of the revenues derived from an oil import fee. The first suggestion is to use the revenues to reduce the deficit. The second suggestion is to use the revenues to pay for certain tax breaks as part of tax reform.

REDUCING THE DEFICIT

Beyond the shadow of a doubt, the most important task facing this Congress is deficit reduction. With a string of triple-digit deficits stretching as far as the eye can see -- and with the Gramm-Rudman-Hollings deficit targets now law -- our efforts must be focused on this important task. As one who strongly opposed Gramm-Rudman-Hollings, I strongly support deficit reduction.

The issue is how those deficits can best be reduced. I have long advocated a combination of reasonable, fair spending restraint in all areas of the budget and new revenues. But by new revenues, I do not mean an unfair, regressive tax. If we're serious about raising revenue, we'd close some of the loopholes in the tax laws that allow wealthy individuals and profitable corporations to avoid paying their fair share of taxes. A true, effective minimum tax would be a first start.

TAX REFORM

An even more preposterous suggestion is to use the revenue from an oil import fee to pay for tax rate reduction. The House-passed tax bill would lower the maximum marginal tax rate from 50% to 38%. There have been suggestions that it should be lowered further, perhaps to 35%, one-half of the 1981 maximum rate. To pay for that reduction, some have suggested an oil import fee.

I can't conceive of a more unfair, inequitable and unreasonable suggestion. Effectively, the supporters of this concept are saying that they will pay for a tax break for the rich by imposing a harsh tax on the poor. Think about it: the wealthiest taxpayers in America would get a break, courtesy of the rest of the nation that must heat their homes and drive their cars to work. An oil import fee used for this purpose could hold the record as the most unfair tax ever devised by man.

MACROECONOMIC IMPLICATIONS OF AN OIL IMPORT FEE

It's important to consider the economic impact that an oil import fee would have. It's also important to contrast that impact with the benefits of falling oil prices. Even though many people assume that an oil import fee would be harmless, I think it's clear that nothing could be further than the truth.

Anyone who's ever taken an economics class can tell you that reducing the deficit by a tax increase alone is bad for the economy; it is generally contractionary. The implications are higher prices, higher unemployment, and slow or negative growth in the gross national product, In economic terms, a tax increase tends to cause an inward shift in the aggregate demand curve. While it's true that this shift could be offset by an easing of monetary policy, the lag in the economy makes this a dubious argument -- and there's no guarantee that the Federal Reserve would ease up on monetary policy. An oil import fee will take money out of the economy and slow the growth our economy has been experiencing.

A Library of Congress study in 1982, which I requested, showed that a $10 per barrel oil import fee would result in an increase in inflation of 0.9%. The estimate indicated that the gross national product could decline by as much as 1.4%, and that unemployment would increase by 0.5%. These economic effects could in turn increase the deficit by $5 billion. A study by economists with the Federal Reserve bank in Dallas in 1985 contained similar findings.

We're waiting for an update from the Library of Congress on the 1982 study. Nonetheless, there aren't many economists who would argue that an oil import fee would be good for the economy. We believe that the updated Library of Congress study will merely confirm the 1982 report.

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FALLING OIL PRICES HELP THE ECONOMY

To demonstrate that an oil import fee is a short-sighted and simplistic solution to our budgetary problems, we need only consider the long-term benefits of falling oil prices. Those benefits are showing up in the economy right now, and will continue -- if Congress doesn't resort to this short-sighted, unfair "solution."

Virtually all economists both in and out of government agree that falling oil prices are a tremendous benefit to the economy -- from the Joint Economic Committee to private consulting firms such as Data Resources, Inc. (DRI). They agree that lower oil prices shift the aggregate supply curve out, resulting in a new equilibrium in the economy at lower prices and higher levels of GNP.

The DRI model indicates that just a $5 per barrel drop in oil prices translates into a 0.5% increase in GNP -- which can in turn reduce the budget deficit by $20 billion. The inflation rate could fall by 1%; unemployment could fall by 0.4%.

Without question, there are very clear benefits in falling oil prices. Just three weeks ago, the conventional wisdom in this town was that the Administration's economic forecast was too optimistic. New deficit predictions, however, indicate that the projections may not have been optimistic enough. It is possible to have growth above 4% this year due to falling oil prices -- but it won't happen if Congress enacts an oil import fee.

OTHER PROBLEMS WITH AN OIL IMPORT FEE

A $5 per barrel oil import fee would increase costs to consumers by $35 billion, but would only raise $6-$7 billion for the federal government in the short term. But over time, as higher oil prices worked their way through the economy and GNP fell and unemployment rose, those revenues would fall off.

An oil import fee would violate our obligations under the General Agreement on Tariffs and Trade, and invite trade retaliation in other areas.

Enactment of an oil import fee by Congress would allow domestic oil producers to raise their prices carte blanche, translating into higher costs for consumers. That means greater profits for the fatcat oil companies as they drove up their prices to match the cost of imported crude. Those higher profits would not, contrary to some reports that you may have heard, be taxed away by the Windfall Profit Tax.

Finally, the primary effects of an oil import fee would be felt in the Northeast and Midwest where 80% of home heating oil is imported. Those citizens would pay more than three times the national average for electricity Low income people in New England would pay 31% of their income for energy assuming a $10 per barrel fee, compared with the nationwide average of 21.7%. The unfairness goes on and on.

CONCLUSION

Mr. Chairman, for every complex problem, there is an easy solution. It is short, simple ... and wrong. An oil import fee is a classic example. It is a shortsighted, simplistic, unfair approach to a very complex problem. I urge you, as colleagues and as leaders of this nation, not to make the tragic mistake of imposing an oil import fee.

Thank you very much.

STATEMENT OF HON. JAMES R. JONES, A U.S. REPRESENTATIVE FROM THE STATE OF OKLAHOMA

Congressman JONES. Thank you, Mr. Chairman, and distinguished members of the committee. I thank you very much for holding this hearing. You have a copy of my prepared testimony, which I would like to have included in the record and I would summarize.

First of all, let me say that I come to support an oil import fee reluctantly because I believe in a free trading system. I proposed this last year in testimony before the House Budget Committee in March of last year and at least urged a standby import fee for the authority to be given to the President. Had we had that standby authority, I don't think we would be facing the kind of problems we have today in the domestic oil industry; but the fact is we don't.

Last year, the President threatened to veto, and clearly there were not enough votes to override a veto in the Congress. I hope that the administration will change its position this year and that both Houses of Congress can move and move rapidly. As I say, I came to this reluctantly for a number of reasons. First of all, there is a very parochial reason—the state of the economy in my State of Oklahoma. Our State's economy is founded principally on oil and gas and on agriculture. Both of those industries are in dire straits today. The oil and gas industry is a good example.

In 1981, we had 984 rigs operating in Oklahoma. At last count, there were 180 rigs operating in my State. Over 80 percent of the rigs have been idled; and these numbers do parallel the national scene where we had 4,500 plus rigs operating in the United States in December 1981; and less than 5 years later, it is down to 1,773 operating. We see that in Oklahoma in human terms, not just the rigs that are idled, but a lot of people are idle. In 1981, nearly 100,000 Oklahomans were directly employed in the oil patch. More than 30,000 are now out of work, unemployed and unable to find work, causing great problems in Oklahoma. So, my first reason is admittedly parochial. Our economy cannot stand being the victim of what I think we are seeing, which is a manipulation of the international oil market; and the oil producers and suppliers in Oklahoma are the victims of that manipulation.

Now, an argument has been made that this oil import fee would be unfairly distributing the cost to the upper Midwest and Middle Atlantic States and New England. The Joint Tax Committee's report indicates that that is not the case, that as a practical matter, the consumers in our part of the country in the South and the West consume about 20 percent more petroleum products than those in the Middle Atlantic and North Central States. So, I am not sure that that argument of unfairly putting the burden on that part of the country is an accurate argument. I also have trouble understanding why so many folks are very quick to place a heavy tax burden on domestic U.S. oil and gas producers and yet, when we propose an attempt to equalize that tax by placing a tax on foreign producers, suddenly it is wrong. It seems that it is OK to tax American producers but not foreign producers, and I don't understand the wisdom of that argument.

My second reason for an oil import fee is wrapped up in what is called national energy policy and national security. If we become dependent again on foreign sources of petroleum, we are likely to face the same kind of consequences we did in 1973-74, which was primarily responsible for the economic problems of all of the 1970's. We find today that about a third—a little more than a third—of our daily usage comes from foreign sources; that is, it is not only creeping up a dependency on energy from foreign sources, but it has a detrimental effect on our trade deficit. Almost $60 billion a year in the trade deficit is due to imported petroleum and petroleum products. Petroleum products present a national security question. I think we have lost about one-third of our refining capacity here in the United States because of the increase in oil products coming from overseas. And I think that argument has to be looked at very, very hard.

The third reason is sort of a byproduct, and it shouldn't be the main reason for even considering an oil import fee; and that is the revenues to be gained that would help reduce this gigantic Federal deficit. As I calculate on the assumptions that I used when we first offered this last year, if you had a $5 import fee, the combination of new revenues coming directly from an oil import fee plus what would be increased income in windfall profits taxes from domestic production would raise $15, maybe $20, billion a year. My judgment is that ought to be applied to lowering the Federal deficit and not be used for financing the tax reform bill that is before you now and which regrettably passed the House and is in your lap. Let me just say what the characteristics of the bill ought to be.

You will write this legislation, but I would suggest to you that first of all it have a sunset attached to it. I don't think we should make this a permanent part of our tax law; and we ought to be required to review an oil import fee every 2 to 3 years or something of that nature.

Second, it seems we ought to use the concept that, Mr. Chairman, you have used in your legislation, and that is to establish a base price and have the fee trigger on as that base price declines and trigger off as it exceeds the base price. And the purpose of that is to have virtually no impact on consumer prices. I think that is a responsible thing to do.

I think we ought to consider perhaps some rebate for those States that have heavy consumption of imported oil or products; but those are the characteristics that I think we ought to have in it. In any event, I think we ought to act quickly. I can only relate to you the conditions in Oklahoma; and it seems to me that if we don't act quickly to stabilize the domestic industry, we are going to lose a substantial part of that domestic industry with more and more bankruptcies and, in my State, that is going to ripple not only in direct unemployment, but it is going to ripple in the commitment we can make to education and to the quality of life in Oklahoma.

It seems to me we ought to be able to at least pass standby authority and give the President that option to use for an oil import fee. Thank you very much, Mr. Chairman.

Senator **Wallop**. Thank you, Congressman Jones. I was musing here on the celibratory nature of one of the findings of the Consumer Federation of America; and I figure that you and Senator Long and I ought to belly up and do our thing for the national welfare and just eliminate the oil industry. If we are going to create six jobs for every job we lose in the oil industry, I guess that just about eliminates unemployment tomorrow; and we wouldn't have to worry about these things. Consumers could think for themselves.

Senator CHAFEE. Mr. Chairman, could I ask a quick question of Mr. Jones?

Senator WALLOP. Yes.

Senator CHAFEE. I will be brief. First, I presume that you, coming from an agricultural State as well as an oil-producing State——

Congressman JONES. That is right.

Senator CHAFEE. You are not persuaded that the benefits that have been outlined for agriculture as a result of this bill are sufficient to persuade you that the bill is not a good proposal? You have heard the suggestions that agriculture will benefit two ways by not having the oil import fee. Or, to put it the other way around, agriculture will benefit from the declining price of oil: First, through cheaper pesticides and, second, through cheaper fertilizers.

Congressman JONES. I can tell you from an Oklahoma point of view that agriculture definitely will not be helped by failure of the domestic oil industry. The more the wells are idled and shut in Oklahoma, the more that is going to cost Oklahoma's farmers. Many of Oklahoma's farmers are barely able to stay away from the bankruptcy court; and the only reason they can is they may have a strip of well producing on their property that gives them a little royalty fee. So, no, it would definitely not help the Oklahoma farmer.

Senator CHAFEE. The other question is this: Before the oil embargo of 1973, oil was selling, I suppose, at something like $8 or $9 a barrel; and the oil industry was doing all right. Now, the possibility is that—what is oil now?—maybe $15 a barrel? It might go down more, but right now it is $15 and, indeed, it has been far higher. Yet, the rigs are idle, as you pointed out in your statistics. Now, why is this? Even putting in the inflation factor, why has the oil industry declined so dramatically despite the fact that it is probably right at the same price it was before the embargo?

Congressman JONES. I think when we became prey to the manipulations of the international oil market in the 1970's, it dislocated so much—everything in the economy—that to have a precipitous decline of prices now requires an adjustment. I am not arguing for a long-term import fee that props prices up forever. What I am saying is that when you have a sudden drop like you have today, when you have the cost of producing a well based on prior factors, when the price drops so much that it costs more to produce it than you are getting for your product, or when you have loans based on $25 oil and you are getting $14 and you can't meet your payments on your loans—that is causing bankruptcies. That is causing dislocations; it is causing problems in the industry. Obviously, I would like to see prices come down for the consumers, but it has to come down in a rational way and not be manipulated down as precipitously and dramatically as has happened in the last several weeks.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator WALLOP. Senator Pell?

Senator LONG. I would like to ask a question of Mr. Jones, Mr. Chairman.

Senator PELL. I will defer to Senator Long, Mr. Chairman.

Senator WALLOP. All right. Go ahead, Senator Long.

Senator LONG. Let me address myself to Mr. Jones for a moment. You asked a question a moment ago, which said that the oil industry was doing all right before the 1973 embargo. My recollection of that is that, during the 17 years prior to 1973, from 1956 to 1973, this Nation had legislation under the so-called Defense amendment that would have permitted it to do a lot more to maintain an oil and gas industry than it did. However, by 1973, the best I could recall from industry sources was that the industry was down to the point that it was merely producing out of inventory. They weren't drilling any exploratory wells, and the headquarters for oil like Shreveport and Lafayette—and I am sure you had areas like that in Oklahoma, such as Tulsa—where the independent oil and gas was, they weren't doing any drilling. All their rigs had been stacked; they were just sitting there. Whatever wells they had in the ground could produce. It didn't cost much to produce what was there; but no more wells were being drilled. Now, when that embargo hit us in 1973, it really created havoc with our producers. Of course, the price went up.

President Nixon told me—as well as others in the White House—that we were going to have energy independence. He said that the embargo demonstrates what can be done to this country. I recall that one time he said that, 10 years from now the Arabs can drink that oil if they want to; we are not going to be needing it. Now, that is the kind of resolve that a nation can muster—once you have to stand in line and then the sign goes up: Sorry, out of oil; sorry, out of gas. We ought to see that that doesn't happen again. Is there any doubt in your mind that, compared to the production costs of the Near East, the OPEC producers in general, or the cost of the Russian oil production, that if this Nation does not take the side of its producers, they will finally wipe out our oil and gas industry?

Congressman JONES. There is no question about that, Senator, and this is not just another commodity. This is not the manufacture of sport coats or something like that. This is vital to national security. If we become dependent again, it is not just our consumers who will have to stand in line and maybe get their oil products in their car, but it is a national security issue. We cannot win a war if we are dependent on foreign sources.

Senator LONG. Has the thought ever occurred to you that, in due course, after these OPEC nations have been hurt enough by the low oil prices at the instance of Saudi Arabia claiming more and more market shares and dropping those prices, that they will say let's put our cartel back together? We are ready to come to your terms, Mr. Yamani. You just tell us what we must do, and we will get with you. If that happens oil prices are going to go up very, very much. And if they put another boycott to us or they make the price far too high, by the time they get through this industry will be exterminated. We aren't going to be able to get the oil from domestic sources.

Congressman JONES. You are absolutely right. It amazes me that memories are so short; that it has only been 11 years since we went through that turmoil of the oil embargo. And the rapidly escalating prices—it will happen again, once they have us in a position where we have nothing to fight back with.

Senator LONG. Thank you, Congressman.

Senator WALLOP. Senator Pell?

[The prepared written statement of Congressman Jones follows:]

STATEMENT OF THE HONORABLE JAMES R. JONES
BEFORE THE SENATE COMMITTEE ON FINANCE
FEBRUARY 28, 1986

OIL IMPORT FEE

Eighteenth century English philosopher Edmund Burke once stated, "to tax and to please, no more than to love and to be wise, is not given to men." Two hundred years later Burke's words ring just as true: There's no such thing as a perfect tax. Or, a perfect fee.

That almost a dozen of my distinguished colleagues from the Senate and the House are also testifying today amplifies this fact. That I am out-numbered almost 4 to 1 by my colleagues from the Northeast is not an accident.

None of the members testifying, however, has come before you more often to talk about the matter of energy policy and its taxation. During my fourteen years in Congress, testifying against further taxation of this beleaguered industry is practically an annual event for me. My purpose today, ironically, is the opposite: to advocate imposition of a new tax on energy imports.

BACKGROUND ON INDUSTRY

The world oil market continues to defy a reasonable level of predictability. The price of oil is falling daily. Not too long ago, prices of $60 per barrel were generally assumed inevitable. Even when prices began to drop in 1982, no one contemplated prices would go below $25 per barrel. Now chaos, rather than order, reigns over worldwide markets. The unthinkable level of $15 per barrel has been reached and passed. No one knows if there is a floor where this free-for-all will stop. There is no foreseeable trough.

As a result of this rapid drop in price, the domestic oil and gas industry through no fault of its own is heading toward disastrous straits. American oil and gas producers are pawns in a game of international market monopoly.

Forces in the Middle East, who once dominated the market, are seeking to reestablish their stranglehold by wiping out the demand stimulus that effective conservation measures have produced, and the market share developed by new suppliers such as Great Britain, Norway, Mexico, and China. OPEC has both barrels of their shotgun loaded, and our domestic producers are in the line of fire with no bullets for their guns.

Years of government regulation, price controls, profit taxes, and confiscatory excise taxes have left domestic producers virtually helpless in this worldwide oil price war.

The impact is stark. For example, in 1981, Oklahoma had 984 operating rigs. Several days ago, at last count, there were 180 rigs operating in my state; over 80 percent of our rigs have been idled. These numbers parallel the national scene. 4,521 rigs operated in the United States in December, 1981. Less than five years later, a mere 1,773 rigs operate.

Behind these statistics, however, there is human loss.

96,500 Oklahomans were at work in the oil patch in 1981. Since that time, over 30,000 citizens of my state have seen their livelihood in the oil industry robbed by forces beyond our nation's boundary -- beyond the sphere of American control.

Since oil was discovered in Oklahoma around the turn of the century, we have become accustomed to the cyclical nature of the energy industry. It is part of our heritage. But these are not times when only the companies started by wild speculators on the upswing of the oil boom are faltering. Established, responsible, well-managed companies are barely staying afloat.

The impact of plummeting oil prices is rippling throughout our economy as well. Financial institutions have either liquidated their energy loan portfolios, drying up virtually all capital for drilling and exploration, or they have very precarious balance sheets.

The failure of The Penn Square Bank, which triggered the near-collapse and costly rescue of Continental Illinois Bank in Chicago, are but two examples of the many effects of the dropping price of oil. Many financial institutions have either closed their doors or ceased making loans secured by oil reserves. This fact is recognized in the publication released yesterday by the Joint Committee on Taxation.

The only thing bleaker than the current situation in the domestic energy industry is a look at the prospects for tomorrow if oil prices continue their precipitous decline.

INVESTMENT PATTERNS: NATIONAL SECURITY CONCERNS

The decrease in domestic oil drilling activity has serious consequences for national security and international relations.

Last year, petroleum imports represented about one-third of our oil needs at a cost of $56 billion. Sharp price declines, left unchecked, will only escalate our trade deficit. Oil imports reflected almost one-half of last year's trade deficit, and we can ill afford to aggravate this situation with additional oil and oil products from abroad.

To maintain the current import ratio, future domestic oil investments must be enormous. If we want to maintain imports at the 30-percent level, a level many consider too high to ensure our nation's energy security, domestic production must increase to about 11.4 million barrels a day by 1994. That requires drilling at least 100,000 new wells each year until then. During the past ten years, the so-called boom period, we only drilled about 60,000 new wells per year.

Capital spending, needed to meet production levels in the next decade, must increase almost two-fold. However, companies are being forced to drastically reduce capital spending. There is hardly a morning the newspapers are not replete with articles on oil company shutdowns, bankruptcies, and contractions.

One company in my state recently announced capital spending plans for 1986 had been slashed 30-percent, a $400 million reduction. Another company just announced termination of over 2,000 jobs.

OIL IMPORT FEE AND DEFICIT REDUCTION

No one likes to see tariffs or protectionism. I have certainly been known as a defender of free trade, but there comes a time when we cannot stand by and watch our industries crumble. If there was ever a time for an oil import fee, it is now.

Let me say at the outset that my advocacy of an oil import fee is based on what I think constitutes sensible energy policy. Whether revenues to reduce the deficit are a by-product of this proposal -- although that is a benefit we should not discount -- is not a motivation for my support.

Such a fee should have a sunset, so that Congress will be forced to reevaluate its decision, and we will not have created an unending revenue pump. My preference is that the fee not be riddled with exemptions and complexity.

In essence, it should be a variable fee. This fee will not harm consumers (as some of my colleagues have alleged) since it would be triggered on by a decrease in prices and triggered off by an increase. Furthermore, I would recommend that my colleagues from the Northeast examine the Joint Committee on Taxation's discussion of the regional issue in their recent publication. It demonstrates that citizens on the Northeast would not necessarily be hurt by an oil import fee disproportionately to other parts of the country.

A variable fee system would achieve market price stability because the price of oil would be predetermined at a base price

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level. A variable fee would close the gap between the established price and the world market price for oil. Decline in the world price would automatically increase the amount of the import fee. An increase in world price would reduce the amount of the import fee, with increases beyond the base level eliminating the fee altogether.

CONCLUSION

Mr. Chairman, the times are extraordinary. Small oil producers, the so-called stripper well operators, comprise 80 percent of the producers in my state, and almost 72 percent nationally. At $15 per barrel, experts predict, almost 60 percent of all stripper wells will be closed. At $10 oil, almost 90 percent will shut down.

The very real threat of $10 oil is at hand. Let's avoid a producer-driven market, where America's producers are out of business and all production comes from the politically volatile, unstable Middle East. Let's take the extraordinary actions now. Otherwise, the specter of long gasoline lines and home heating oil shortages awaits us when our foreign supply is interrupted by political upheaval or economic blackmail.

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STATEMENT OF HON. CLAIBORNE PELL, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator Pell. Thank you very much, Mr. Chairman and colleagues, my own good colleague from Rhode Island, Mr. Chafee, and others here. I very much appreciate this opportunity to appear before you in opposition to an oil import fee.

Basically, the oil import fee concept is more along the lines, and perhaps should be labeled as, an oil industry support program, akin to our agriculture support program in violation of the free market economy which I think should prevail in this case. Basically, too, an oil import fee is nothing less than a poisoned arrow aimed straight at the heart of the economy of our own State of Rhode Island and New England and the northeast generally. Because of this, 13 Senators from this region have joined with me in sponsoring a resolution [S. Res. 335] opposing any new taxes on imported oil and oil products. Now, I ask unanimous consent that a copy of that resolution be included in the hearing record.

Senator Wallop. Without objection.

Senator Pell. Thank you. Our opposition to an oil import tax, though, is not based solely on regional economic interests. An oil import tax would also be damaging to our national economy. An import tax of $5 a barrel would reduce GNP by 1 percent at the end of 2 years, decrease employment by 400,000 jobs, and increase inflationary pressures. These were the conclusions of a study done by economists of the Federal Reserve Bank of Dallas, and I would ask unanimous consent that a copy of that study be inserted in the record at this point.

Senator Wallop. Without objection.

[A copy of Senate Resolution 355 and a copy of the study done by the Federal Reserve Bank of Dallas follow:]

III

99TH CONGRESS
2D SESSION

S. RES. 335

Expressing the Senate's opposition to the imposition of a fee on imported crude oil and refined petroleum products.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 27), 1986

Mr. PELL (for himself, Mr. CHAFEE, Mr. MITCHELL, Mr. COHEN, Mr. KERRY, Mr. WEICKER, Mr. MOYNIHAN, Mr. HUMPHREY, Mr. KENNEDY, Mr. D'AMATO, Mr. HEINZ, Mr. METZENBAUM, and Mr. RUDMAN) submitted the following resolution; which was referred to the Committee on Finance

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RESOLUTION

Expressing the Senate's opposition to the imposition of a fee on imported crude oil and refined petroleum products.

Whereas, a fee on imported crude oil and refined petroleum products would directly increase the costs of production and manufacturing for industries using petroleum products;

Whereas, the increased production costs resulting from such a fee would impair the ability of industries to compete in international markets;

Whereas, such a fee would directly increase the costs to other users of petroleum products, including those dependent on oil and oil products to heat their homes, and who use oil-generated electricity;

Whereas, the increased costs to industry and to homeowners from such a fee would not be uniformly distributed geographically or among economic sectors, but would be borne disproportionately by those industries and regions most dependent on petroleum products: Now, therefore, be it

Resolved, That it is the sense of the Senate that neither the President nor the Congress should impose fees on imported crude oil and refined petroleum products.

○

III

99TH CONGRESS
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S. RES. 335

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Economic Review

Federal Reserve Bank of Dallas
September 1985

1 **Immigration from Mexico:
Effects on the Texas Economy**
James E. Pearce and Jeffery W. Gunther

The industries in Texas most sensitive to immigration reform are agriculture, construction, and durable goods manufacturing. Workers already residing in Texas most directly in competition with illegal immigrant workers are Hispanics and adults without high school degrees. These conclusions follow from analysis of the 1980 Census data on Mexican-born Texas residents who speak no English. The analysis assumes that the occupational distribution of these workers approximates that of illegal immigrants from Mexico.

15 **Effects of Reducing the Deficit
with an Oil Import Tariff**
Ronald H. Schmidt and Roger H. Dunstan

Reducing the federal budget deficit with an oil import tariff would be more detrimental to the economy than would other commonly used tax policies. Although most taxes reduce economic growth by raising prices or lowering income, the magnitudes of the induced distortions are different for different tax policies. Simulations reveal that a broader-based tax that raises identical revenue, such as an income tax surcharge, has smaller adverse effects on GNP and inflation than does an oil import tariff. The simulations also show that an import tariff would provide short-term protection to the energy industry by raising energy prices, but the gains in the energy sector are dwarfed by the losses in the rest of the economy.

Effects of Reducing the Deficit with an Oil Import Tariff

Ronald H. Schmidt

Senior Economist
Federal Reserve Bank of Dallas

Roger H. Dunstan

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Federal Reserve Bank of Dallas

The concerns raised by the magnitude of the current U.S. budget deficit have increased interest among some lawmakers in sources of additional revenue.[1] Recent declines in oil prices, combined with the weakness in domestic energy industries, have focused some of that interest on taxing oil imports. Proponents argue that levying a tariff on imported oil would have the multiple advantages of generating revenues for the U.S. Treasury, promoting domestic oil exploration and production, and reducing dependence on foreign oil.[2]

An oil import tariff, however, would have widespread effects on the economy. As demonstrated by past responses to energy price increases, a rise in oil prices can induce changes in energy consumption that reduce the economy's aggregate output and raise unemployment during the adjustment process.

This paper examines the effects on the U.S. economy of an oil import tariff and discusses the national security issue of reducing oil imports.[3] In particular, simulation experiments conducted with a large macroeconometric model examine the effect of an oil import tariff of $5 per barrel. The effects are measured against two standards: a base case with no tax imposed and a simulation imposing an income tax surcharge that raises the same revenue as the import tariff.

If a tax increase is considered necessary to reduce the budget deficit, the macroeconomic results tend to argue against adopting an oil import tariff.

The views expressed are those of the authors and do not necessarily reflect the positions of the Federal Reserve Bank of Dallas or the Federal Reserve System. The authors would like to thank Flint Brayton, W. Michael Cox, and John H. Loney.

[1] Addressing the Federal Government deficit is a controversial issue. Some believe that additional taxes are necessary to reduce the deficit. Others argue against new taxes because they believe that spending cuts or economic growth will eventually reduce the deficit. This article does not take a position on how, or even if, the federal deficit should be reduced. We concentrate on the impact of one suggested new tax, an oil import tariff.

[2] For example, see Mark Potts, "Independent Oil Refiners Call for Import Protection," *Washington Post*, 22 February 1985, Business section, and "The Product Import Battle," *Oil Daily*, 22 February 1985, 4.

[3] For expositional simplicity we have used the term "oil imports," which includes not only crude oil but also petroleum products.

Simulation results suggest that an income tax surcharge could raise equal revenues with less impact on the economy. The tariff was found to result in larger reductions in real gross national product (GNP) and employment and higher inflation than an income tax surcharge designed to raise equal revenue.

From the perspective of energy independence, the simulations provide evidence that oil imports could be reduced—at least during the period in which the tariff is maintained. The higher price resulting from the tariff does stimulate additional production during the term of the simulations.

In the long term, however, the tariff is unlikely to promote energy security. The most promising areas for major discoveries are in the Alaskan and offshore fields, which are expensive to explore and develop. As long as oil prices continue to trend downward and the tariff is expected to be lifted eventually, the financial prospects for finding reserves are likely to remain poor.

Tax distortions in the economy

Economic theory suggests that relative market prices of commodities tend to reflect a pattern of transactions and production that maximizes economic welfare. By changing relative prices, taxes alter the consumer's choice of commodities and a producer's use of inputs. Tax policies discourage consumption of commodities with prices that are higher after imposition of the tax and favor consumption of commodities with relatively lower prices as a result of the tax. Any tax that changes relative prices of different goods and services, therefore, distorts economic decision-making.

Assuming that a producer maximizes profits with his choice of inputs, purchased at the pretax rates, any changes the tax causes in producer behavior are likely to reduce output. Similarly, consumers choose goods that maximize their utility on the basis of after-tax prices. The imposition of a tax yields a less preferred outcome, unless the tax is imposed to correct existing distortions (such as taxes to reduce pollution or congestion).[4]

In practice, nearly all tax policies distort relative prices. The function of our study is to determine which tax results in the smallest distortion. Most research suggests that the amount of distortion varies directly with the price elasticity of demand for the commodity.[5] With a given percentage price increase, purchases of a commodity whose demand is elastic fall more than those of a commodity whose demand is inelastic.

The argument has further implications. Commodities for which demand is relatively elastic are often those for which substitutes are readily available. When taxes raise the price of such a commodity, consumers and producers decrease their use of the taxed commodity and increase their use of substitutes. As the tax induces consumers and producers to change their purchases, some of the burden of the tax is shifted to other commodities in the form of higher prices.

This process of shifting occurs with the oil import tariff. The tariff changes the relative price of a factor of production if, as we assume, the tax is included in the price charged to oil consumers. A producer faces higher costs and is likely to reduce output, lay off workers, and decrease capital utilization. Some of the increased cost of production is shifted forward to final consumers in the form of higher prices for goods using oil in their production. Energy users with the capability of switching between fuels—especially industrial consumers and electric utilities—can avoid the effects of price increase by switching to natural gas or coal.

Furthermore, fuel switching would probably bid up the prices of substitute energy products. These energy price increases would then force increases in the production costs of other goods. Such increases would result in further losses of real income for the consumers who purchase those goods.

The preceding discussion highlights the point that there is widespread shifting of the burden of some taxes. By causing producers and consumers to alter their decisions, such shifting may introduce inefficiencies or distortions into the economy that reduce aggregate production. This shifting is not uniform for all taxes, however. An income tax surcharge would also generate some economic distortions but, if placed on all sources of income, would be more difficult to avoid. At the margin, it could induce some individuals to reduce investments or substitute leisure for work because the returns to work would fall relative to the returns to leisure. Nevertheless, the economic effects of introduced distortions are likely to be relatively small compared with those for an oil import tariff.

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[4] See William J. Baumol, "On Taxation and the Control of Externalities," *American Economic Review* 62 (June 1972): 307–22.

[5] Optimal commodity taxation is based on the Ramsey pricing rule, which relates optimal tax rates inversely to the price elasticity of demand. See Anthony B. Atkinson and Joseph E. Stiglitz, *Lectures on Public Economics* (New York: McGraw-Hill Book Company, 1980), 366–93, and Arnold C. Harberger, "Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay," *Journal of Economic Literature* 9 (September 1971): 785–97.

The degree to which a tax is shifted has one further important implication for revenue raising. If the tax is easily shifted (or applied to a small tax base), the rates applied to achieve a given revenue target must be higher than for a tax applied to a larger base that cannot be shifted easily. As discussed below, both the shifting capability and the smaller tax base in the oil import case forced the imposition of considerably larger tax rates on oil imports than on income to raise equal revenue.

Effects on the economy of an oil import tariff

Alternative tax plans have different effects on relative prices and economic growth. Deriving quantitative estimates of the relative effects of different tax policies is possible through the use of simulation models. Although all models are imperfect mirrors of the real world, they give some insight into the interrelationships of economic variables. A comparison of different scenarios can provide some information on the magnitudes of the potential consequences to help rank various tax policies.

Simulation experiments were conducted using a modified version of the MIT-Penn-SSRC (MPS) model of the U.S. economy. The model, which contains over 120 behavioral equations and over 200 identities, is operated and maintained by the Board of Governors of the Federal Reserve System. We modified the structural model to increase the detail in the energy sector, but the bulk of the model was unchanged. A discussion of the nature of the modifications made to the MPS model structure is presented in the Appendix.

Three simulations were conducted with the model: a base case with no tax increase, a case with an oil import tariff applied, and a case with an income tax surcharge. Because forecasts produced by simulation models depend on a large number of assumptions about other factors, only changes in the tax parameters were allowed. Government expenditures, monetary growth rates, and oil prices, while allowed to change over time, were kept identical across scenarios.[6]

The simulations compared forecasts for the period from the first quarter of 1985 through the second quarter of 1988. Nominal oil prices were assumed to decline from $27.25 per barrel for imported oil at the beginning of 1985 to $24.75 per barrel by the end of the forecast period. Monetary policy was assumed to set growth rates for the money supply—in this case, M1—that fell from an average of 6.7 percent in 1985 to 4.5 percent in 1988. Nominal federal expenditures (less interest payments) were assumed to increase 17.5 percent between the first quarter of 1985 and the second quarter of 1988.[7]

Conducting the oil import tariff experiment required certain additional assumptions. For simplicity it was assumed that the Organization of Petroleum Exporting Countries (OPEC) does not or is unable to retaliate by imposing an oil embargo or raising prices.[8] A tax of $5 per barrel was imposed on all imported oil for the period from the third quarter of 1985 to the middle of 1988, with the tariff revenues entering into the budget as federal customs duties. Because domestic oil prices were assumed to follow the after-tax price of imported oil, domestic oil prices increased by the amount of the tax.[9] The net effect of the tariff was to reduce the budget deficit an average of $8.6 billion in each of the three years.[10]

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[6] The experiments yielded differential increases in the consumer price index (CPI). The different increases in inflation, in turn, may have different effects on government expenditures that are indexed to the CPI. Because of the difficulty in determining which segments of government spending would be affected—the decision is political as well as statutory—such increases in nominal spending were ignored in both alternatives. Similarly, the responsiveness of Federal Government expenditures to slight changes in GNP was also ignored. Social service would be the category of spending most likely to be affected as unemployment rises. State and local governments are responsible for a significant portion of this spending category. It is unlikely that the marginal increases in Federal Government purchases would change the relative impact of the import tariff or income tax. If anything, the increased government spending required by the increased unemployment in the import tariff example would strengthen the case against the tariff.

[7] Because comparisons are limited to those between scenarios, the assumed money growth rates, oil prices, and government expenditures are relatively insignificant. Although the level of GNP and most other variables would be changed if different assumptions were used, the differences between scenarios—which are the focus of this study—would not be materially affected.

[8] Additionally, an oil import tariff may contravene the General Agreement on Tariffs and Trade, raising the possibility of countervailing tariffs by countries exporting petroleum to the United States. Nevertheless, we assume that such tariffs are not imposed.

The income tax surcharge experiment was designed to raise the same amount of revenue as the oil import tariff over the same period. The resulting 2.2-percent tax rate was levied on aggregate taxable personal income after deductions, exemptions, and exclusions.

The results from the simulations provided evidence that the two tax policies would have significant macroeconomic effects. The immediate effect is a reduction of the deficit. Beyond that, both tax policies can be expected to lead to short-run declines in real GNP and employment because a reduction in the deficit without offsetting monetary policy is generally contractionary. Even though these policies reduce the deficit by an equal amount, however, the magnitudes of the real GNP and employment effects are quite different.

Differences in macroeconomic consequences stem from fundamental differences in the way the two taxes distort the economic system. The import tariff affects the system by changing the price of a factor of production—oil. Because oil is an important factor of production, the higher price is passed on to the final prices of other goods, leading to a general increase in the price level. The increase in the price level affects the economy by raising nominal interest rates, driving down investment, and reducing the real wealth of consumers.

In contrast, an income tax surcharge has its principal effect on consumption, lowering aggregate demand for goods rather than changing relative factor prices and the price level. Both the inflation rate and interest rates are reduced by the income tax, but the magnitudes of these changes are minor compared with the increases in the import tax case. (For a more complete discussion of the differences in the effects of the two tax policies, see the accompanying box.)

In general, the income tax introduces smaller distortions than the import tariff. The tariff, by changing factor prices, has the dual effect of removing revenue from the economy through the tax as well as causing the price level to rise. In effect, the tariff is partially shifted to the rest of the system in the form of higher costs. The income tax, on the other hand, removes the same level of revenue from the economy without significantly affecting prices.

The different effects the tax policies have on real GNP are traced in Chart 1. For both the import tariff and the income tax cases, the percentage difference in GNP relative to GNP in the base case for the same period is plotted. The model projections indicate a substantially larger negative effect on the economy in the case of the import tariff than for the income tax surcharge. This effect was especially significant at the end of 1986 and in early 1987: GNP was nearly 1 percent lower as a result of the tariff, while the slowdown in the economy from the income tax was nearly over by then. In both cases the effects on GNP were diminished toward the end of the period.

The two tax policies also yielded measurable differences in unemployment rates. The unemployment rate during the latter half of the period was projected to be nearly four-tenths of a percentage point higher with an import tariff than in either the base case or the income tax case (Chart 2). This difference is equivalent to more than 400,000 jobs. Consistent with the hypothesis that an income tax is

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[9] We assumed that coal and natural gas prices were not significantly affected by the tariff. The justification for this assumption is that most gas is contracted for long periods. Such contracts require considerable time to pass before gas prices can fully adjust to changes in oil prices. Only recently have some gas prices begun to fall, and others (especially for old gas) remain controlled at below market prices. The current surplus of coal and natural gas will also reduce upward pressure on prices.

[10] The tariff is a large percentage of oil prices because of the limited capability of the tariff to raise revenues. Although an oil import tariff stimulates revenues from the windfall profit tax (through the effect on higher domestic oil prices), the windfall profit tax, the tariff, and the higher expenditures on oil are deducted from corporate income, reducing corporate income tax collections. The amount of the tariff is somewhat arbitrary, largely reflecting the amount various groups have suggested as appropriate. Part of the rationale for a $5 increase is that it would not raise nominal oil prices above the peak levels in 1980-81. The Congressional Budget Office also uses $5 in its analysis. See U.S. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, pt. 2 of 1985 Annual Report (Washington, D.C.: Government Printing Office, February 1985).

Chart 1

Effects on Real GNP of the Two Policies

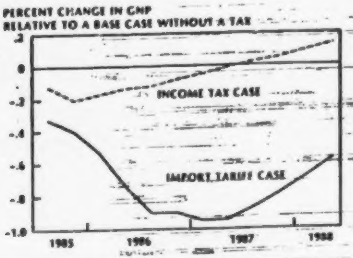
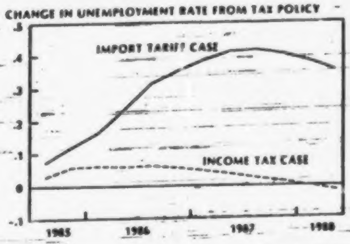


Chart 2

Effects on Unemployment



difficult to shift, the effect on employment in the income tax case was relatively small.

The increase in energy prices resulting from imposition of the import tariff led to an immediate acceleration of inflation. The wholesale price index for fuels jumped 12 percent immediately as a result of the tariff and remained essentially unchanged for the rest of the period. Because monetary policy, as measured by the growth rate of M1, was assumed not to react to the tax policies, the initial price changes in the oil tariff case caused nominal interest rates to rise compared with the other cases. It is worth noting that since the growth of M1 remained unchanged, the inflation rate subsequently slowed and eventually returned to the base case rate. By the end of the modeling period, the inflation rate was almost equal to the rate in the base case.

The two policies also had minor differential effects on international trade. The current account deficit decreased with imposition of the import tariff, partially offsetting the effect of the decline in GNP. The value of total imports fell, led by the drop in petroleum imports. The reduction in domestic consumption following the decline in GNP contributed to the fall in total imports.

The income tax scenario also yielded changes in exports and imports. The effects were minor, however, and generally followed the movements in GNP.

Because the import tax led to a relative change in factor prices, effects on the use of inputs—particularly a shift toward less energy-intensive capital—should be expected. In the relatively short time horizon modeled in this scenario, however, significant changes in the mix of the capital stock did not emerge.

Energy independence

Despite the poor performance of the oil import tariff when compared with an income tax, other considerations—in particular, a desire to reduce dependence on foreign sources of energy—may still favor an oil import tariff. By raising oil prices, a tariff might increase domestic oil production and decrease oil imports, thereby making the United States less vulnerable to the threat of an oil supply disruption.[11] To some, this prospect makes the tariff

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[11] Much of the recent concern about petroleum imports has stemmed from the issue of imported petroleum products. Reduced demand for petroleum products has left significant excess capacity in the refining industry. Many domestic refiners have closed plants, and more closures are threatened. The argument has been made that if additional refineries are closed, the domestic refining industry will not have enough capacity to supply all needed petroleum products in the event of an embargo or some other kind of supply disruption. The model did not contain sufficient detail to simulate the results for this industry. Presumably, petroleum product imports would be reduced by the tariff along with crude oil imports, providing some measure of protection for the domestic refining industry.

A Simplified Macroeconomic Model

The MPS model, like other large macroeconomic models, is an immensely complex structural model of the economy.[1] In the MPS model, over 300 variables are simultaneously determined for each period of the forecast horizon.

Despite this complexity, at the heart of most structural macroeconomic models—including the MPS model—lies a relatively simple theoretical framework known as an *IS-LM* model.[2] This simplified framework can be used to understand the differences generated by the two tax policies in the MPS model.

A typical *IS-LM* model is shown graphically in Figure A. It contains two curves, an *IS* curve and an *LM* curve, each drawn as a function of real income (GNP) and real interest rates. Each point along the *IS* curve represents an equilibrium combination of income and interest rates that is consistent with a specific level of government spending, consumption, and investment. Consumption and investment functions are assumed to be negatively related to interest rates and positively related to income. Consequently, the *IS* curve is downward sloping: equilibrium combinations with higher interest rates are consistent with lower consumption and investment levels—which implies lower income. The *IS* curve separates the possible combinations of income and interest rates into three regions: on the *IS* curve, where supply equals demand; to the right of the *IS* curve, where supply exceeds demand; and to the left of the curve, where demand exceeds supply. A reduction in government spending or an increase in taxes will shift the *IS* curve to the left.

Similar in construction, the *LM* function represents possible equilibrium combinations of real income and interest rates, given the current stock of money. Money demand is positively related to income and negatively related to interest rates; higher income levels are then consistent only with higher interest rates, given a constant money supply. Consequently, the *LM* curve is positively sloped. An increase in the money supply or a decrease in the price level shifts the *LM* curve to the right.

Typically in the *IS-LM* model, prices are held constant and output is allowed to change in response to excess supply or demand in the commodities market. The model can easily be extended, however, to allow for variable prices by including a real output (*Y/P*) line (Figure B). The *Y/P* line represents the current level of output, given a particular combination of input prices and output prices. Output is assumed to be a function of factor inputs, including labor, capital, and energy. Firms are assumed to maximize profits and are free to hire each of the inputs; thus, the quantity of each input is determined by real input costs. An increase in the real unit price of labor, for example, will involve a reduction in the amount of labor hired and will lower output, shifting the *Y/P* line to the left.

Full equilibrium occurs at the point where the *IS* and *LM* curves and *Y/P* line intersect. The intersection

Figure A
The IS-LM Model

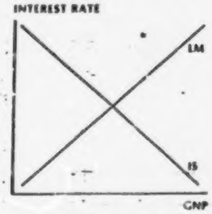
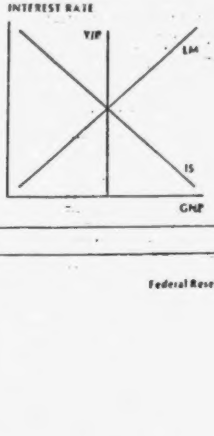


Figure B
The IS-LM Model with a Real Output (Y/P) Line Added



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[1] Similar models are operated by Chase Econometrics, Data Resources, Inc., and Wharton Econometric Forecasting Associates.

[2] A more complete description of the IS-LM framework can be found in most macroeconomics textbooks. See, for example, Robert J. Gordon, *Macroeconomics*, 2d ed. (Boston: Little, Brown and Company, 1981), or Charles W. Baird and Alexander E. Cassuto, *Macroeconomics: Monetary, Search, and Income Theories*, 2d ed. (Chicago: Science Research Associates, 1981).

represents a level of income, prices, and interest rates that satisfies equilibrium conditions simultaneously in the goods and money markets, given existing production relationships.

The different effects of the two tax policies can be explained by using this framework. Imposition of the income tax directly reduces consumption at each level of GNP and shifts the *IS* curve to the left. Decreased consumption leads to an excess supply of goods and to downward pressure on output prices. The lower product prices are not, in general, matched by equiproportional reductions in input prices, which raises factor costs to firms. Higher input costs cause firms to reduce output—a shift of the *Y/P* line to the left. As seen in Figure C, the new equilibrium solution has lower GNP and lower interest rates.[3]

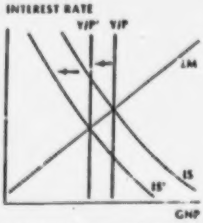
The oil import tariff has a different effect. Because the tariff leads to an increase in the cost of a factor of production (oil), producers decrease use of that factor. Assuming that perfect substitutes for the input are not available, purchases of other factors decline and output is reduced. The *Y/P* line shifts to the left as output decreases, creating an excess demand for goods. Prices rise in response to the excess demand for goods, but the increase in the price level does not fully offset the higher input costs, leaving the *Y/P* line to the left of its original position. Because of the increase in the price level—and the assumption that monetary policy does not accommodate the higher price level—the real money supply falls. Eventually there is a leftward shift in the *LM* curve, which is consistent with a rise in interest rates (Figure D).

Without estimates of the relationships behind the *IS-LM* curves and the *Y/P* line, graphical comparisons of the relative effects of an import tariff and an income tax are difficult. Interest rates are clearly higher in the former case, but GNP is lower in both. The price level is also higher in the import tariff case.

In the model simulations, the decline in GNP is larger in the import tax case. For the most part, the reduction in GNP is the result of the effects of higher interest rates and prices on production and consumption. Lower prices and interest rates in the income tax case partially offset the decline in production, yielding smaller GNP reductions. Although there are also offsetting effects in the import tax case, these shifts are not as large.[4]

Figure C

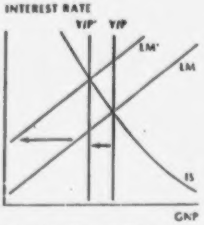
The Effect of Increasing Income Taxes



An increase in income taxes lowers consumption at each level of GNP, shifting the IS curve to the left to IS'. The resulting excess supply of goods leads to reduced final output prices, causing the Y/P line to shift to the left to Y/P'. A new equilibrium is established and has lower GNP and lower interest rates.

Figure D

The Effect of Imposing an Oil Import Tariff



Imposing an oil import tariff increases production costs. Producers reduce output, shifting the Y/P line to Y/P'. Resulting excess demand for goods causes output prices to rise, leading to a leftward shift of the LM curve to LM'. The new equilibrium has lower GNP and higher interest rates.

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[3] We have described only the principal shifts of the *IS*, *LM*, and *Y/P* curves for expositional clarity. As the economy moves to a new equilibrium, secondary shifts occur in all the curves in each case and clearly affect the final result, but the dominant effects are those described in the text.

[4] For a more complete description of the relationships between wages, prices, interest rates, and output, see Flint Brayton and Eileen Mauskopf, "The MPS Model of the United States Economy," *Economic Modelling*, forthcoming, p. 3.

Chart 3
Oil Imports

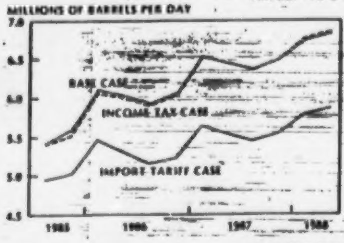
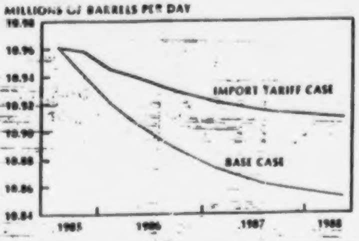


Chart 4
Domestic Oil Production



a doubly attractive tax instrument, despite the evidence that an import tariff would have stronger negative macroeconomic consequences than other possible tax plans.

The concern over dependence on foreign oil imports is not without merit. In response to U.S. support for Israel in the 1973 Middle East war, an embargo was imposed on oil shipments to the United States, and OPEC production was decreased. The resulting increase in prices contributed significantly to higher inflation and unemployment throughout much of the world. Despite increased non-OPEC production and reduced petroleum demand, OPEC remains an important, albeit diminished, source of supply for petroleum consumed in this country. The importance of OPEC, especially Arabian OPEC countries with large reserves, is likely to grow as reserves outside OPEC decline.

From the perspective of reduced petroleum imports, the simulations indicate that the oil import tariff would be successful. As shown in Chart 3, oil imports were virtually unchanged by the income tax surcharge but fell more than 14 percent (nearly 1 million barrels per day) with the tariff.

Similarly, while domestic oil production continued its long-term decline in all cases, the decline was slower in the import tariff case (Chart 4). The increased domestic price, it should be noted, did not reverse the trend toward reduced production. Even with the tariff, inflation-adjusted prices at the end of the period were lower than at the present time. Consequently, the tariff could protect domestic producers in the near term, but the tariff does not fundamentally alter the pessimistic outlook for oil prices and domestic production.

There are, however, ambiguities with the general argument that an oil import tariff promotes energy independence. Most important, the national security argument requires the existence of high volumes of domestic production at the time of a crisis. If an oil import tariff merely increases current production at a time when there is no significant threat of a shutoff, long-term energy independence may actually be reduced. The policy may simply hasten depletion of existing reserves unless the tariff encourages domestic producers to discover and develop new fields that would otherwise not be developed.

It also needs to be recognized that the potential for large discoveries in the United States is somewhat limited, given the extensive exploration that has already occurred. The potential for large additions to reserves appears greatest in areas that are relatively expensive to develop, such as offshore or in Alaska. Since real oil prices decline in all scenarios, incentives to engage in new exploration are limited. This is especially true if the development costs are expected to be high, as they are with the Alaskan and offshore sources of oil.

The results generated by the MPS model in the oil import tariff experiment are typical of events that normally follow from protectionism. Domestic energy industries gain from the tariff in the short run, but their gains are more than offset by losses in income and employment elsewhere in the economy.[12] Furthermore, if the policy is lifted after the three-year period, the normal processes of adjustment—the shift of resources away from energy to other industries—would be retarded by the tariff, making eventual adjustment more disruptive.

Overall, the effects on national security are ambiguous. The decline in the reserve base might be reversed or reduced, depending on the perception of the longevity of the tariff and the responsiveness of exploration activity to the higher domestic price. The import tax should lead to increased domestic oil production in the short run, although at the possible cost of reducing domestic reserves.

Conclusions

The results here generally argue against the use of an oil import tariff. Simulation experiments suggest that more broadly based taxes would have less distorting effects on the economy. Compared with an income tax surcharge, the import tariff was found to generate higher inflation and unemployment and lower GNP. The negative consequences of higher energy prices on output are considerably larger than the reduction in consumption caused by a tax on income.

From the perspective of energy independence, an oil import tariff may not have a significant effect on augmenting reserves. Unless oil prices are expected to begin to rise, development of costly new reserves will be limited. Consequently, an oil import tariff would most likely encourage current production of oil at the expense of future production.

This research indicates the importance of the planned duration of the tax in designing an oil import tariff. If the tax is to promote domestic oil exploration and the development of alternative energy sources, it is essential that producers can be led to believe that the tax will not be quickly abandoned. From the perspective of increased energy conservation, consumers must also believe oil will remain expensive and that they should invest in energy-saving appliances and insulation.

Furthermore, if the tariff is to be temporary, the adjustment costs that would result with sudden removal of the tariff could be large. To the extent that the import tariff forestalls the more gradual decline in investment and employment that would ordinarily occur, the sudden removal of the tax would force a sharp adjustment to lower energy prices.

Finally, we assumed that an oil import tariff could be imposed unilaterally without retaliation by OPEC or other oil-exporting countries. In reality, OPEC or other oil-exporting countries could retaliate either by imposing an oil embargo on any country imposing a tariff or by imposing countervailing import tariffs on all goods and services from that country. On the other hand, such a move could trigger rapid price declines if the loss of exports cut further into OPEC's dwindling production and destabilized the cartel.

---

[12] Similar results were reported in a recent study by Wharton Econometric Forecasting Associates. See Sharon Denny, "Product Import Tariff Could Harm General Economy, Panel Is Told," *Oil Daily*, 7 June 1985, 2.

Appendix

Changes to the MPS Model

The MPS (Massachusetts Institute of Technology-University of Pennsylvania-Social Science Research Council) model is an aggregate model of the U.S. economy.[1] The model, which is maintained and modified by the staff of the Board of Governors of the Federal Reserve System, has been used over the years as a tool to provide input into the possible consequences of monetary and fiscal policy regimes.

The model currently contains 332 structural equations: 124 behavioral equations and 208 identities. At its center is a growth model of the economy, with output generated by a Cobb-Douglas production function that uses labor, capital, and energy and with consumption decisions based on life-cycle theories. Forecasts are made on a quarterly basis.

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[1] See Flint Brayton and Eileen Mauskopf, "The MPS Model of the United States Economy," *Economic Modelling*, forthcoming, for a detailed discussion of the model and its properties.

Considerable detail is included to model taxation. Income taxes are formed through a complicated procedure that takes into account different marginal tax brackets, deductions, exemptions, and exclusions, weighted by demographic factors. Corporate taxes are levied on corporate income after removal of other taxes (including customs duties and state taxes), expenses, and depreciation, with the treatment of depreciation changing as tax codes change over time.

The international sector is represented, with the exchange rate determined in the model to equilibrate the current account and capital account flows. The value of imported oil is included in the international trade flows.

Before our changes, the energy sector of the original model was for the most part exogenous. Total Btu (British thermal unit) consumption was determined endogenously as a function of the wholesale price index of fuels and real GNP, with all energy prices determined exogenously. Energy consumption was then divided among fuels by applying exogenously specified shares. Domestic production was determined exogenously, with imports specified as the difference between domestic consumption and production. Energy prices generally affect the rest of the model through investment in capital equipment and consumption of durables (including automobiles). Exogenously determined windfall profit tax receipts are included as indirect business taxes, which appear in the federal budget identity and the calculation of corporate income.

To conduct the experiments discussed in this paper, several additions and alterations were required. First, the shares of petroleum, natural gas, and coal consumption were made endogenous by estimating share equations for petroleum and coal as a function of time and the price of each fuel relative to the prices of other goods. A relative increase in petroleum prices then leads to an erosion of petroleum's share of total energy consumption. The share equations were of the form

$$
\begin{aligned}
(1)\quad OILSHR = {} & \underset{(6.45)}{.6687} - \underset{(-2.50)}{.0019}\, TIME \\
& - \underset{(-8.03)}{.0622}\, [\ln(OILP)/\ln(OTHER)] \\
& + \underset{(3.83)}{.0690}\, [\ln(NGASP)/\ln(OTHER)] \\
& + \underset{(1.12)}{.0498}\, [\ln(COALP)/\ln(OTHER)]
\end{aligned}
$$

and

$$
\begin{aligned}
(2)\quad COALSHR = {} & -\underset{(-1.49)}{.0890} + \underset{(6.01)}{.0026}\, TIME \\
& + \underset{(5.35)}{.0239}\, [\ln(OILP)/\ln(OTHER)] \\
& - \underset{(-3.75)}{.0389}\, [\ln(NGASP)/\ln(OTHER)] \\
& - \underset{(-.27)}{.0070}\, [\ln(COALP)/\ln(OTHER)],
\end{aligned}
$$

where *OILP*, *NGASP*, *COALP*, and *OTHER* are price indexes for oil, natural gas, coal, and non-energy goods. The share of energy attributed to natural gas is the residual. Figures in parentheses are *t* statistics.

Second, to capture the effect of changes in oil prices on domestic production, a domestic oil supply equation (*OIL*) was estimated and included in the model:

$$
\begin{aligned}
(3)\quad \ln(OIL) = {} & \underset{(2.88)}{.6757} + \underset{(2.74)}{.3990}\, \ln(OIL_{t-1}) \\
& + \underset{(2.16)}{.2922}\, \ln(OIL_{t-2}) \\
& + \underset{(2.35)}{.0093}\, \ln(OILP_t).
\end{aligned}
$$

Third, to determine the windfall profit tax revenues endogenously beginning in the third quarter of 1985, the following formula was used:

$$(4)\quad WPT = (OILP - BASE) \cdot RATE \cdot OIL,$$

where the *BASE* price is set at $22 per barrel and appreciates 1.6 percent each quarter, the tax *RATE* is set at 25 percent, and total domestic oil production (*OIL*) is measured in billions of barrels per year. (In calculating national income account figures, all variables are put in annual terms.) The quarterly growth rate of 1.6 percent (6.55 percent at an annual rate) was chosen to proxy for a real increase of zero to 2 percent in the base price (assuming inflation is slightly above 5 percent).[3]

It is worth noting that the revenues from imposition of an import tax cannot be calculated by multiplying the amount of the tariff by the quantity of imports. First, the increased domestic price leads to higher windfall profit tax collections. Second, revenues from the tariff and windfall profit tax, as indirect business taxes, are deducted from corporate income. This process reduces revenues from the corporate profits tax. Lastly, demand for imports falls as a result of the higher price of petroleum.

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[3] This procedure grossly simplifies the actual calculation of the windfall profit tax. In actuality, domestic oil production is classified into three general tiers, each of which has a different base price that appreciates at different rates. The tax for a tier is then determined as the difference between the selling price and the base price for that category multiplied by a tax rate that is specific to each tier. The total revenues calculated using this procedure were approximately the same as those estimated by the U.S. Congressional Budget Office in *Reducing the Deficit: Spending and Revenue Options*, pt. 2 of 1985 Annual Report (Washington, D.C.: Government Printing Office, February 1985).

The New England Council Inc.

Suite 510 • 1800 Massachusetts Avenue, N.W. • Washington, D.C. 20036 • (202) 659-8860

BOARD OF DIRECTORS

February 13, 1986

TO: Interested Parties

FROM: Nicholas P. Koskores
Vice President, Washington Office
The New England Council, Inc.

RE: Regional Argument against the Oil Import Tax

See attached.

Headquarters • 120 Boylston Street • Boston, Massachusetts 02116 • (617) 542-2580

NEW ENGLAND CANNOT AFFORD AN OIL IMPORT FEE

Despite much progress to reduce its dependency on oil as an energy source, New England, lacking most energy resources, relies on petroleum products for over 60 percent of its energy needs. New England's economy remains sensitive to oil price changes. Enactment of proposals calling for a tariff on imported oil, therefore, would threaten economic growth, raise already high electricity prices for consumers, and place a disproportionate burden on New England to fund reductions in the nation's budget deficit.

Oil import fees have been proposed in the past to (1) increase federal revenues, and/or (2) provide an incentive for reducing U.S. dependence on oil, especially from foreign sources. Current proposals commonly call for a $5 tax on each barrel of imported oil yielding approximately $10 billion in revenues to the government. But the costs to the national economy, particularly in New England, would be severe compared to the benefits of raising new tax revenue. The American consumer, not foreign producers of oil, would bear much of the burden of the tax in the form of higher oil prices.

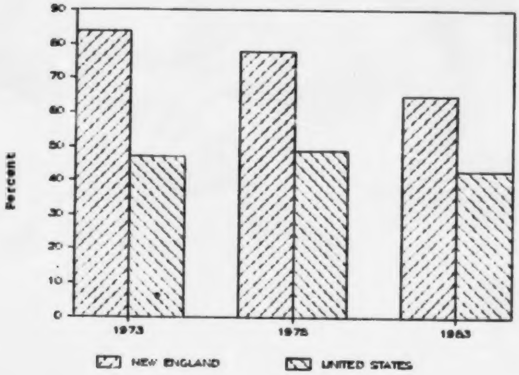
The Negative Impact on New England

New England is more heavily dependent than the nation on oil, both as a primary energy source and as a fuel source for generating electricity. The six New England states are among the eighteen nationally that produce no oil. New England's economy, as a result, is highly vulnerable to oil supply and price changes. So although, from 1973 to 1983, New England decreased its actual consumption of oil by a dramatic 38 percent, it is still 22 percent more dependent than the nation as a whole on oil as an energy source. By 1983, New England still relied on oil for 65 percent of its total energy usage, compared to the much lower 43 percent figure for the nation (see Chart I).

CHART I

DECLINING RELIANCE ON OIL AS AN ENERGY SOURCE

New England and U.S. Consumption of Oil, 1973-1983
(As a Percent of Total Energy Consumption)



Source: The New England Council, Inc.;
State Energy Data Report, May 1985

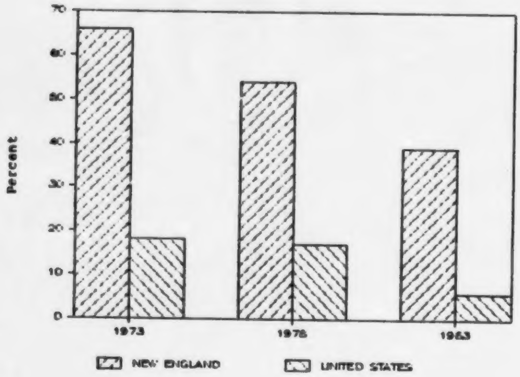
New England's reliance on oil to generate electricity is also high, and the great disparity between the region's reliance and the nation's minimal reliance on oil places New England electricity consumers in an especially vulnerable position. New England has diversified its electricity generation sources.

From 1973 to 1983, oil consumption as a percent of the total energy inputs used to generate electricity declined from 65.8 percent to 41.1 percent. But the U.S., by 1983, relied on oil for only 6 percent of its electricity generation (see Chart II).

CHART II

DECLINING USE OF OIL FOR ELECTRICITY GENERATION

New England and U.S. Use of Oil to Generate Electricity
1973-1983
(As a Percent of Total Energy Used to Generate Electricity)



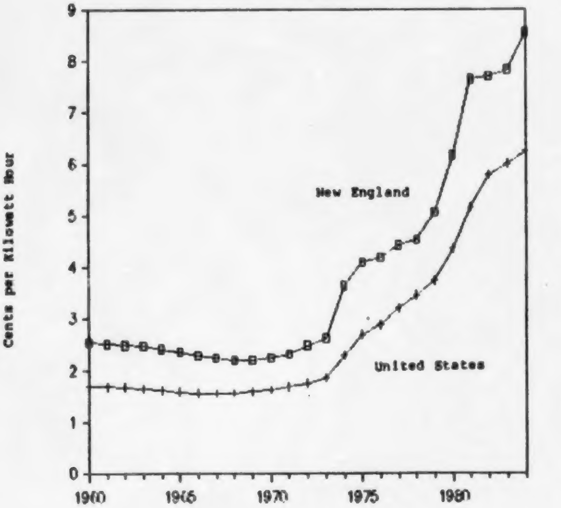
Source: The New England Council, Inc.;
Energy Information Administration, 1985

This region's heavy and costly dependence on oil is reflected in its higher than average electricity costs. In 1984, New England's average electricity prices were 38 percent higher than the U.S. average (see Chart III). At the time of the 1974 oil price shock, the price differential was closer to 60 percent. New England, since that time, has made excellent progress in reducing the tremendous electricity cost disadvantage it has with the rest of the nation. This cost disadvantage, however, still hurts the competitiveness of New England not only in attracting new businesses, investment, and workers, but also in maintaining current economic prosperity.

CHART III

NEW ENGLAND'S ELECTRICITY COST DISADVANTAGE

New England and U.S. Average Electricity Prices, 1960-1984
(Cents Per Kilowatt Hour)



Source: The New England Council, Inc.
Edison Electric Institute, 1960-1984

New Englanders are already paying 38% more for their electricity, and are seven times more dependent on oil for generating electricity. Everyone uses electricity. It is only substitutable over the long-term and in some cases is not substitutable at all. Consumers can choose whether or not they heat their homes with electricity, but cannot realistically choose how to power their light switches.

What would an oil import fee cost New England's industrial, commercial, and residential electricity consumers? The New England Council estimates that if a $5 per barrel tariff on imported oil had been enacted in 1984, it would have cost New England's electricity consumers as much as $185 million in higher electricity prices. The average consumer's bill would have risen as much as 2.9 percent above the rate paid in the absence of the fee (see Chart IV and Appendix I). The costs to electricity consumers would depend ultimately on the responses of the international oil market to the new tariff. Using Congressional Budget Office predictions on these reponses, and The New England Council's economic models on New England's electricity prices, the region's electricity users could have expected to pay between $122.721 million and $185.169 million in additional costs under the oil import fee.

CHART IV

OIL IMPORT FEE PRICE SHOCKS TO NEW ENGLAND ELECTRICITY CONSUMERS, 1984

Under a $5 per Barrel Fee on Imported Oil

	Range of Average Electricty Price Increases (a)	Range of Total Electricity Cost Increases (b)
Low*	1.9%	$122.721 million
High*	2.9%	$185.169 million

*note: for explanations of assumptions made to estimate electricity price responses to an oil import fee, see Appendix 1.

(a) Electricity price (cents per kwh) increases above the actual 1984 level

(b) Total electricity cost increases above the actual 1984 level

Source: The New England Council, Inc.

The detrimental impact of an oil import fee is not limited, however, to electricity costs. Petroluem products are used, for example, to heat homes and power engines. Price increases for these products would erode income and consumer spending, raise the prices of other products using petroleum as an input, and cause disruptions in markets resulting in lower employment and economic growth. Prices of non-oil energy sources would also rise as increased demand for alternative energy sources pushed up prices in those markets. The role of sudden increases in energy prices in the spiraling inflationary economy of the late 1970s should not be forgotten. Indeed, current price stability in the economy is partially attributed to falling oil prices. The U.S. and especially New England would lose much of the economic benefit of falling energy prices if another price shock were added to the market through an oil import fee. In a 1984 study, the Congressional Budget Office estimated that a $5 per barrel tariff implemented in mid-year 1982 would have triggered at least a 0.5 percent increase in inflation after one year alone; the U.S. economy would have lost $15.4 billion in real goods and services, and the unemployment rate would have increased at least 0.1 percent, or a loss of 100,000 jobs after the first year (see Chart V).

CHART V

MACROECONOMIC EFFECTS OF ALTERNATIVE OIL IMPORT TARIFFS
ON THE U.S. ECONOMY

Tariff Size ($/barrel)	GNP Loss (% of Projected GNP) a/	Increase in Unemployment Rate (% points) b/	4 Quarter Increase in Price Level (%) c/	8 Quarter Increase in Price Level c/
$2	0.2 - 0.3	less than 0.1	0.2 - 0.3	0.1 - 0.2
$5	0.5 - 0.7	0.1 - 0.2	0.5 -0 .6	0.3 - 0.4
$10	1.0 - 1.4	0.3 - 0.4	0.9 - 1.2	0.6 - 0.9

a/ Constant $ GNP loss after 4 quarters relative to the baseline of no tariff

b/ Percentage point change in the unemployment rate after 4 quarters relative to the baseline of no tariff

c/ Percent change in GNP deflator relative to the baseline of no tariff

Source: Congressional Budget Office

Taking Steps to Reduce Oil Reliance

Despite falling oil prices, New England continues to diversify its energy sources away from oil. The argument that an oil import fee would force consumers to reduce dependence on foreign and domestic oil as an energy source is redundant to trends that have already occurred in the absence of such a fee. Consumers, both business and residential, have adjusted longer term oil consumption patterns. This ranges from changing consumer preferences toward fuel efficient cars, to greater reliance on coal, nuclear, and hydroelectric sources of energy to generate electricity - trends that will not be reversed in the near future. An oil import fee, serving as a tool in shaping national energy policy, would add little to warrant its other economic costs. This is especially true for the New England region.

In summary, consumers and businesses in the New England region, rather than foreign oil producers would suffer the brunt of such a tax. Also, New England already suffers from cost disadvantages by having higher than average prices for energy products and other commodities. An oil import tax would drive up business production costs and hurt the future economic development of the region.

Appendix I

Estimating the Economic Impact of Oil Import Fees

The costs of oil import fees to New England electricity consumers ultimately depend on responses of the international oil market to the new tariff; the domestic price changes in petroleum products purchased by utilities; and subsequent changes in wholesale electricity prices.

Imported crude oil prices would initially rise with the new tariff. Domestic crude oil prices would also rise and domestic purchases of crude oil would decline. Foreign oil producers, having substantial control over the international oil market, would be forced to make changes in production and pricing levels that would affect worldwide levels. If foreign producers lowered their prices to maintain relatively stable production levels, then the market price of crude oil in the U.S. would not rise by the full amount of the tariff and consumers would only bear part of the cost of the tariff. If foreign producers lowered their production to support higher oil prices, much of the price burden of the tariff would be pushed onto U.S. consumers. This last scenario would be most likely to occur since there is an excess world supply of oil currently in the market (foreign producers would be able to absorb relatively more production cuts).

Using CBO assumptions about responses to an oil import fee in the international oil market, both scenarios were developed to determine the change in petroleum prices in the United States. In the first instance, foreign producers assumed one third of the price burden of the fee, resulting in crude oil prices rising by $3.30/barrel with a $5/barrel fee. In the second instance, the entire price burden of the fee was passed on to consumers, resulting in a $5/barrel increase in crude oil prices. The first scenario corresponds to the low range and the second scenario to the high range of the New England electricity price changes in Chart IV.

An econometric model was developed to determine how an oil import fee passed through the petroleum products markets to New England utilities and ultimately to electricity consumers. Using statistical relationships in portions of DRI's national energy model, a consumer electricity price model for New England was developed. Consumer electricity prices were determined by wholesale electricity prices which were a function of unit costs and relative purchases of input fuels used to generate electricity. The petroleum input portion of the weighted wholesale price was determined by a weighted composite of domestic and imported crude oil prices and unit labor costs. The model was run for the period 1974:1 to 1984:12, with the effects of an oil import fee on consumer prices (in cents/kwh) derived from a simulation for 1984.

Senator **Pell**. Thank you. In my statement, though, I will focus on why an oil import tax would be unfair, damaging, discriminatory, and really very unacceptable to our area.

New England is a high-cost energy region. We do not have access to the low-cost natural gas, coal, and hydroelectric power available to industry and consumers in other parts of our nation. We rely on oil for 65 percent of all energy consumption, compared with a national average of only about 40 percent. And of the oil consumed in New England, more than 60 percent of that oil is imported. In addition, 41 percent of our electricity is generated using oil, compared with just 6 percent that is used to generate oil on a national basis. As a result, electricity prices in New England are almost 40 percent—38 percent--higher than the national average, and other energy costs are similarly high. This places our industry and consumers in our region at a huge competitive disadvantage.

During the 1970's when oil prices rose to $30 a barrel and more, New England paid the price. Through conservation and conversion to other natural sources and energy sources, we reduced our oil consumption by 38 percent. And because of the competitive disadvantage, we lost tens of thousands of jobs to other regions with lower energy costs.

And now, when world oil prices have declined, we are told that the national interest requires an oil import tax to boost the price of our primary source of energy. We are told that the tax would be painless because world oil prices have declined. The fact is that it would not be painless for our part of the country. A tax on oil falls most heavily on New England industry and consumers. It would increase the energy costs for our manufacturers and homeowners, but would leave untouched those industries in other areas that use low-cost hydroelectric, coal, or natural gas energy instead of oil.

The New England Council, an organization of 1,400 of the largest businesses in our region, has prepared an excellent summary of the impact of an oil import tax on the economy of the region; and I would ask unanimous consent that that study, too, may be made part of the hearing record.

Senator **Wallop**. Without objection.

[The New England Council summary follows:]

the New England Council, Inc.

Suite 510 • 1800 Massachusetts Avenue, N.W. • Washington, D.C. 20036 • (202) 659-8860

BOARD OF DIRECTORS

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Vice President, Washington Office
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RE: Regional Argument against the Oil Import Tax

See attached.

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Oil import fees have been proposed in the past to (1) increase federal revenues, and/or (2) provide an incentive for reducing U.S. dependence on oil, especially from foreign sources. Current proposals commonly call for a $5 tax on each barrel of imported oil yielding approximately $10 billion in revenues to the government. But the costs to the national economy, particularly in New England, would be severe compared to the benefits of raising new tax revenue. The American consumer, not foreign producers of oil, would bear much of the burden of the tax in the form of higher oil prices.

The Negative Impact on New England

New England is more heavily dependent than the nation on oil, both as a primary energy source and as a fuel source for generating electricity. The six New England states are among the eighteen nationally that produce no oil. New England's economy, as a result, is highly vulnerable to oil supply and price changes. So although, from 1973 to 1983, New England decreased its actual consumption of oil by a dramatic 38 percent, it is still 22 percent more dependent than the nation as a whole on oil as an energy source. By 1983, New England still relied on oil for 65 percent of its total energy usage, compared to the much lower 43 percent figure for the nation (see Chart I).

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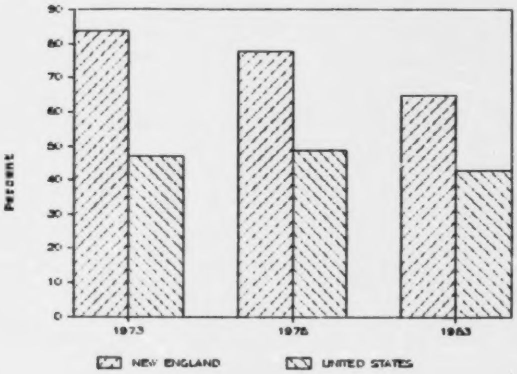

Source: The New England Council, Inc.;
State Energy Data Report, May 1985

New England's reliance on oil to generate electricity is also high, and the great disparity between the region's reliance and the nation's minimal reliance on oil places New England electricity consumers in an especially vulnerable position. New England has diversified its electricity generation sources.

AVAILABLE

From 1973 to 1983, oil consumption as a percent of the total energy inputs used to generate electricity declined from 65.8 percent to 41.1 percent. But the U.S., by 1983, relied on oil for only 6 percent of its electricity generation (see Chart II).

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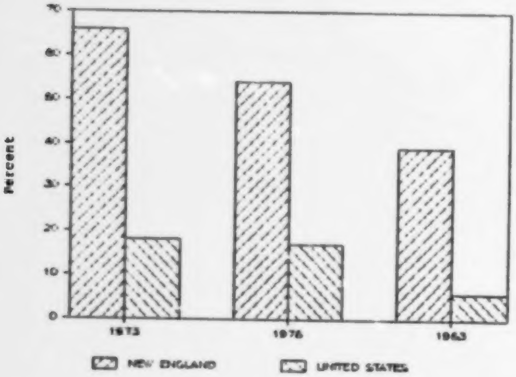

Source: - The New England Council, Inc.;
Energy Information Administration, 1985

This region's heavy and costly dependence on oil is reflected in its higher than average electricity costs. In 1984, New England's average electricity prices were 38 percent higher than the U.S. average (see Chart III). At the time of the 1974 oil price shock, the price differential was closer to 60 percent. New England, since that time, has made excellent progress in reducing the tremendous electricity cost disadvantage it has with the rest of the nation. This cost disadvantage, however, still hurts the competitiveness of New England not only in attracting new businesses, investment, and workers, but also in maintaining current economic prosperity.

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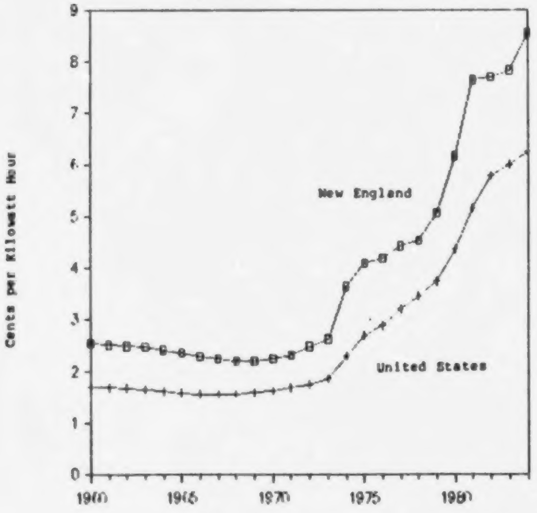

Source: The New England Council, Inc.
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AVAILABLE

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Source: The New England Council, Inc.

The detrimental impact of an oil import fee is not limited, however, to electricity costs. Petroluem products are used, for example, to heat homes and power engines. Price increases for these products would erode income and consumer spending, raise the prices of other products using petroleum as an input, and cause disruptions in markets resulting in lower employment and economic growth. Prices of non-oil energy sources would also rise as increased demand for alternative energy sources pushed up prices in those markets. The role of sudden increases in energy prices in the spiraling inflationary economy of the late 1970s should not be forgotten. Indeed, current price stability in the economy is partially attributed to falling oil prices. The U.S. and especially New England would lose much of the economic benefit of falling energy prices if another price shock were added to the market through an oil import fee. In a 1984 study, the Congressional Budget Office estimated that a $5 per barrel tariff implemented in mid-year 1982 would have triggered at least a 0.5 percent increase in inflation after one year alone; the U.S. economy would have lost $15.4 billion in real goods and services, and the unemployment rate would have increased at least 0.1 percent, or a loss of 100,000 jobs after the first year (see Chart V).

CHART V

MACROECONOMIC EFFECTS OF ALTERNATIVE OIL IMPORT TARIFFS
ON THE U.S. ECONOMY

Tariff Size ($/barrel)	GNP Loss (% of Projected GNP) a/	Increase in Unemployment Rate (% points) b/	4 Quarter Increase in Price Level (%) c/	8 Quarter Increase in Price Level c/
$2	0.2 - 0.3	less than 0.1	0.2 - 0.3	0.1 - 0.2
$5	0.5 - 0.7	0.1 - 0.2	0.5 -0 .6	0.3 - 0.4
$10	1.0 - 1.4	0.3 - 0.4	0.9 - 1.2	0.6 - 0.9

a/ Constant $ GNP loss after 4 quarters relative to the baseline of no tariff

b/ Percentage point change in the unemployment rate after 4 quarters relative to the baseline of no tariff

c/ Percent change in GNP deflator relative to the baseline of no tariff

Source: Congressional Budget Office

Taking Steps to Reduce Oil Reliance

Despite falling oil prices, New England continues to diversify its energy sources away from oil. The argument that an oil import fee would force consumers to reduce dependence on foreign and domestic oil as an energy source is redundant to trends that have already occurred in the absence of such a fee. Consumers, both business and residential, have adjusted longer term oil consumption patterns. This ranges from changing consumer preferences toward fuel efficient cars, to greater reliance on coal, nuclear, and hydroelectric sources of energy to generate electricity - trends that will not be reversed in the near future. An oil import fee, serving as a tool in shaping national energy policy, would add little to warrant its other economic costs. This is especially true for the New England region.

In summary, consumers and businesses in the New England region, rather than foreign oil producers would suffer the brunt of such a tax. Also, New England already suffers from cost disadvantages by having higher than average prices for energy products and other commodities. An oil import tax would drive up business production costs and hurt the future economic development of the region.

Appendix I

Estimating the Economic Impact of Oil Import Fees

The costs of oil import fees to New England electricity consumers ultimately depend on responses of the international oil market to the new tariff; the domestic price changes in petroleum products purchased by utilities; and subsequent changes in wholesale electricity prices.

Imported crude oil prices would initially rise with the new tariff. Domestic crude oil prices would also rise and domestic purchases of crude oil would decline. Foreign oil producers, having substantial control over the international oil market, would be forced to make changes in production and pricing levels that would affect worldwide levels. If foreign producers lowered their prices to maintain relatively stable production levels, then the market price of crude oil in the U.S. would not rise by the full amount of the tariff and consumers would only bear part of the cost of the tariff. If foreign producers lowered their production to support higher oil prices, much of the price burden of the tariff would be pushed onto U.S. consumers. This last scenario would be most likely to occur since there is an excess world supply of oil currently in the market (foreign producers would be able to absorb relatively more production cuts).

Using CBO assumptions about responses to an oil import fee in the international oil market, both scenarios were developed to determine the change in petroleum prices in the United States. In the first instance, foreign producers assumed one third of the price burden of the fee, resulting in crude oil prices rising by $3.30/barrel with a $5/barrel fee. In the second instance, the entire price burden of the fee was passed on to consumers, resulting in a $5/barrel increase in crude oil prices. The first scenario corresponds to the low range and the second scenario to the high range of the New England electricity price changes in Chart IV.

An econometric model was developed to determine how an oil import fee passed through the petroleum products markets to New England utilities and ultimately to electricity consumers. Using statistical relationships in portions of DRI's national energy model, a consumer electricity price model for New England was developed. Consumer electricity prices were determined by wholesale electricity prices which were a function of unit costs and relative purchases of input fuels used to generate electricity. The petroleum input portion of the weighted wholesale price was determined by a weighted composite of domestic and imported crude oil prices and unit labor costs. The model was run for the period 1974:1 to 1984:12, with the effects of an oil import fee on consumer prices (in cents/kwh) derived from a simulation for 1984.

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Senator **Pell**. Thank you. In summary, an oil import tax or an oil industry support program is not in the national interest. It is, in addition, highly discriminatory in its impact on my own State of Rhode Island and its neighboring States of the Northeast. I believe revenue increases will be necessary as part of a balanced effort to reduce Federal Government budget deficits, and I am prepared to support fair and equitable revenue increases, but not an oil import tax. Perhaps a fairer tax or a broader based tax on energy might be a gasoline tax; but let's not go down this route of an oil import fee. And here, I recall the words of George Santiana: Those who forget the lessons of history are condemned to repeat them.

I remember when I first came to the Congress in the early 1960's, under President Kennedy's leadership, we eliminated a similar program that was called an Oil Import Quota Program; and the country I believe, was better off for that action. And now, we are seeking to go in reverse.

I thank you very much for this opportunity to be here.

Senator **Wallop**. Thank you, Senator Pell. I would like to say in the interest of Gramm-Rudman and printing and a number of other things, that those studies to which you referred will be made part of the committee's files and referenced in the record.

Senator **Pell**. I will leave that to your generosity. Thank you.

Senator **Wallop**. Thank you. Senator Bingaman?

Senator **Chafee**. I just want to say, Mr. Chairman, in connection with Senator Pell's statement that this is a position he has long held. This isn't a position that has come about just because of this suggestion. And he has been very active in resisting oil import fees for a good long time. So, we appreciate his fine statement.

Senator **Pell**. Thank you very much indeed, sir.

Senator **Wallop**. Senator Bingaman?

[The prepared written statement of Senator Pell follows:]

STATEMENT BY SENATOR CLAIBORNE PELL

Testimony prepared for delivery before the Senate Committee on Finance on Friday, February 28, 1986, at 9 a.m. on legislation to impose import fees on oil and oil products.

Mr. Chairman,

I appreciate this opportunity to appear before your committee to convey to you strong opposition to the imposition of taxes on imported oil and oil products.

An oil import fee is nothing less than a poisoned arrow aimed straight at the heart of the economy of the State of Rhode Island, and the New England and Northeastern states generally.

It is because of this that 13 senators from this region have joined with me in sponsoring a resolution (S. Res. 335) opposing any new taxes on imported oil and oil products. I ask that a copy of that resolution be included in the hearing record.

Our opposition to an oil import tax, however, is not based solely on regional economic interests. An oil import tax would also be damaging to our national economy. An import tax of $5 a barrel would reduce Gross National Product by 1% at the end of two years, decrease employment by 400,000 jobs, and increase inflationary pressures.

Those were the conclusions of a study done by economists of the Federal Reserve Bank of Dallas, and I submit for the hearing record a copy of that study.

In my statement this morning, however, I will focus on why an oil import tax would be unfair, damaging, discriminatory, and unacceptable to the New England region.

New England is a high-cost energy region. We do not have access to the low-cost natural gas, coal, and hydro-electric power available to industry and consumers in other parts of our nation. We rely on oil for 65 per cent of all energy consumption, compared with a national average of about 40 per cent. And, of the oil consumed in New England, more than 60% is imported. In addition forty-one percent of our electricity is generated using oil, compared with just 6 per cent nationally.

As a result, electricity prices in New England are 38% higher than the national average, and other energy costs are similarly high. This places the industry and consumers of our region at a huge competitive disadvantage.

During the 1970's, when oil prices rose to $30 a barrel and more, New England paid the price. Through conservation and conversion to other energy sources, we reduced our oil consumption by 38 per cent. And because of the competitive disadvantage, we lost tens of thousands of jobs to other regions with lower energy costs.

And now, when world oil prices have declined, we are told that the national interest requires an oil import tax to boost the price of our primary source of energy. We are told that the tax would be painless because world oil prices have declined.

The fact is that it would not be painless for New England. A tax on oil falls most heavily on New England industry and consumers. It would increase energy costs for our manufacturers and homeowners, but would leave untouched those industries in other areas that use low-cost hydro-electric, coal or natural gas energy instead of oil.

The New England Council, an organization of 1,400 of the largest businesses in the region, has prepared an excellent summary of the impact of an oil import tax on the economy of the region, and I submit a copy of that study for the hearing record.

In summary, an oil import tax is not in our national interest, and it is in addition highly discriminatory in its impact on my own State of Rhode Island and its neighboring states of the Northeast. I believe revenue increases will be necessary as part of a balanced effort to reduce federal government budget deficits and I am prepared to support fair and equitable revenue increases, but not an oil import tax.

I urge the members of the Finance Committee to reject these proposals for taxes on oil imports.

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STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator **Bingaman**. Thank you, Mr. Chairman. I appreciate the chance to speak this morning, and I want to commend you for the leadership you have shown on this important issue.

The United States has enjoyed a period of relative energy stability largely because of extensive drilling and exploration activity between 1973 and 1982 and because of successful conservation efforts. However, the domestic oil industry today is faced with rapidly declining prices, oversupply, and increased competition from lower priced imports of crude oil and petroleum products. Industry has also had to restructure to meet the demands of merger activity and now faces the uncertainty of proposed changes in our tax laws, which this committee knows a great deal about.

These factors are undercutting exploration and production efforts in the United States. Since 1981, nearly 346,000 jobs have been lost in the oil and gas industry. Although almost 82,000 wells were drilled in 1984, the rig count and other indicators point to a significantly lower number in 1985, and the past 2 months have already seen a substantial additional decrease in drilling permits, down 13 percent from 1985 levels. Just as the industry responded to the need for more drilling in the 1970's and early 1980's, oversupply and weak prices are now forcing the industry to cut back on its activity. Slashes over the past few weeks in capital spending for exploration and development by major producers such as ARCO, TENECO, Philips, and AMOCO, I think, prove this point very well. Falling prices do threaten national security, as Congressman Jones was indicating. The impact could have several forms: reduce stripper oil production, an end of Alaskan exploration, reduce Outer Continental Shelf exploration, and reduce natural gas demand.

These factors serve only to leave U.S. oil in the ground and to threaten this additional domestic industry. As drilling production and exploration are cut back, refinery capacity lowered, and imports of crude and product increased, the inevitable result will be that the U.S. industry will be weakened and we will return to a greater dependence on foreign oil. In only 1 year since 1970 has the nation found as much oil as it has produced. That was in 1980; and since then, domestic reserves have declined to 27.8 billion barrels, which is the lowest level since 1951.

As lower oil prices cause the rate of drilling to drop, the shrinkage of these reserves accelerates. That will make the U.S. more dependent on foreign sources of oil. Without any exploration program, the nation's reserves could drop by half by 1990, with production likely to fall as well.

The Energy Information Agency itself predicts a doubling of imports by 1995. Energy imports cost the U.S. $51.7 billion in 1984 and amount to almost half of the nation's balance of trade deficit for that year. Clearly, the nation would benefit most from long-term stability in the oil market, which would in turn ensure the preservation of a constant level of drilling in this country. To assure this, a variety of proposals have been suggested. Mr. Chairman, I favor a simple standby oil import license fee applicable both to crude oil and to products and tied to a specific price level.

This would establish a floor for domestic oil prices, and by limiting the amount by which prices could fall, such a fee would remove much of the uncertainty that clouds the domestic industry's present investment climate. A fee would help ensure that the production from relatively high costs and low volume stripper wells and from areas like Alaska and the deep offshore is not squeezed out of the market by cheaper, unreliable sources of foreign oil. Furthermore, a fee would mean that foreign producers would pay a fair tax on oil that float into the U.S. as a result of foreign dependence.

Most importantly, the fee would effectively set the world price for oil at a level which would provide price stability and allow our producers to continue oil and gas exploration and production. Mr. Chairman, I would suggest that any short term losses to our economy as a result of this kind of a fee would not compare with the devastating impact of a collapse of our domestic energy industry. Now, it is true that the President currently has the authority to impose an oil import fee under the Trade Expansion Act of 1962, but he has been unwilling to recognize that it is in the national interest to do so. Unfortunately, the administration seems oblivious to the potential consequences of declining prices. Last week, Secretary of Energy Harrington testified before the Senate Energy and Natural Resources Committee, and he made the following statement, and I quote: "Energy is no longer a destabilizing force in our economy."

I believe that statement indicates little understanding of the seriousness of the energy situation and demonstrates the kind of short-term perspective that has come to characterize Federal Government policy in energy. The Congress must take the lead in recognizing the importance of our energy needs and, if enacted, an oil import fee would prevent the U.S. from returning to greater and greater dependence on foreign sources of energy. It would enable the domestic industry to remain viable in the future, and it would preserve Governmental tax revenues in the event of a fall of world oil prices and stop the tax subsidization of imported oil. We must end the complacency that currently clouds our energy future and realize that the growing threat to our nation's desire for energy independence. I believe an oil import fee could help move us in that direction. Thank you for the opportunity to testify, Mr. Chairman.

Senator WALLOP. Thank you, Senator Bingaman. And I have statements from Senator Nickles and Senator Durenberger to insert in the record at this point.

I see that Senator Hart has entered the room, so we will go to him, and then we will hear from Mr. Wendt from the State Department.

[The prepared written statements of Senators Nickles and Durenberger follow:]

U.S. SENATOR

Don Nickles

OKLAHOMA

FOR IMMEDIATE RELEASE

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Statement of Senator Don Nickles
The Taxation of Petroleum Imports
Senate Committee on Finance
February 28, 1986

Mr. Chairman:

There is considerable discussion today about the wisdom of implementing a so-called oil import fee. And while there may be some questions raised as to the long-term effects of such a policy, it is important to focus not just on the import fee proposal but on the Federal government's entire energy policy.

At one time or another, I have heard most members of this body say that what America needs is energy independence. To be free from the stranglehold of OPEC. No one disagrees.

Then why is it that this Congress continually enacts policies counter to its energy independence goals? The Federal government has done more to inhibit America's energy security than OPEC and every other energy producing country combined.

It may be good politics for many in Congress to bash "big oil" back home, but this rhetoric fuels the drive which has led to a regressive national energy policy.

Fearing "big oil" in 1980, Congress imposed the Windfall Profits Tax on domestic producers. This tax had the effect of penalizing our American energy industry and encouraging foreign imports of oil.

The amount of windfall profits tax collected since passage in 1980 is as follows:

	1980	1981	1982	1983	1984	Est.'85
GROSS	6.9	23.4	18.5	12.2	9.17	6.4
NET	4.3	[illegible]	9.5	5.7	3.9	3.0

This represents an equivalent tax per barrel as indicated below:

1980 - 6.65
1981 - 9.03
1982 - 6.35
1983 - 4.25
1984 - 3.91

Where is the wisdom in penalizing our domestic producers and giving OPEC a free ride? This Senator sees none.

At the very minimum, a fair and thoughtful policy on oil should be exactly the opposite of what we have today. The Windfall Profits Tax should be repealed and imports should have to pay.

I stated to President Reagan on January 24 that I hoped he would reconsider his position on the oil import fee based on the premise that it is not a tax but an equalization fee.

World oil prices have fallen by over $15 per barrel or by 50% since December and reductions in consumer prices are already happening. This recent decline in oil prices has not been caused by the demise of OPEC but by the calculated strategy of a couple of major exporting nations trying to manipulate the market for future gain. Therefore, we don't see pure market principles at work but calculated maneuvers by government entities to increase their control over the world oil market.

I believe it would be unwise for our government to sit idly by and allow countless American producers and refiners to go bankrupt while the Saudis and others are tightening the screws on oil producing countries. As a bare minimum, let's require that they pay at least the same tax that our domestic producers have been forced to pay since 1980. The average windfall profits tax for the lower 48 states has averaged more than $5 per barrel since passage of the windfall profits tax.

I would hope that an equalization fee would be used not to create new Federal spending programs, but to decrease the national deficit.

There are other issues which should be addressed in reforming U.S. energy policy, such as the deregulation of natural gas. We, in the energy committee, have been working to reverse current punitive policies, and I would encourage this committee and others in this body to join us in this effort.

An oil equalization fee would be a first step toward regaining the losses we have suffered in years past at the hands of OPEC. Let us not lose this present opportunity to make a positive change.

OPENING STATEMENT BY SENATOR DAVE DURENBERGER

Hearing on Oil Import Fees
Subcommittee on Energy and Agricultural Taxation
February 28, 1986

Mr. Chairman, I think we in this Committee are in much the same position as the shepherd whose job it is to protect his sheep from wolves. We have to be aware of wolves in sheep's clothing.

We can say that we are considering using oil import fees in order to meet the President's tax reform goals and still end up with a revenue neutral bill. Or that we would like to use the revenues to reduce the deficit. Or that falling world oil prices will result in an increased dependence on foreign supplies of energy and before we know it we will be in the same situation as we were in the mid-70s, suddenly at the mercy of OPEC.

These are all serious concerns and merit our attention.

But I am afraid that the bottom line is that we want to protect the domestic petroleum industry. And I fear that instead of solving these problems as we would like, we'd be creating far worse ones.

The list of potential problems is long, witnesses yesterday attested to that, and I'm sure we will hear more about them today.

o Important trading partners will be hurt.

o Petroleum based industries will be at a competitive disadvantage in the world market place.

o The agricultural industry will be particularly hard hit as costs for fuel and fertilizer skyrocket.

o Certain regions of the country will benefit at the expense of others.

o It portends a return to import quotas and possibly price controls.

o It is regressive.

o And it puts more money in the pockets of the domestic oil industry than it does the United States Treasury.

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PAGE THREE

I SAY this because my baptism into the Finance Committee in 1979 was the windfall profits tax debate which taught me a lot about markets, government & short-sighted economic policy and energy-based Fiscal policies.

I MUST ADMITT THAT I APPROACH THESE HEARINGS, AND THIS ISSUE, WITH A PREJUDICED OPINION AND A GREAT DEAL OF SKEPTICISM AS TO THE MERITS OF ANY SORT OF FEE ON IMPORTS OF PETROLEUM PRODUCTS.

I SAY THIS BECAUSE MINNESOTA IS ONE OF THE REGIONS WHICH WOULD BE HARD HIT. MINNESOTA FARMERS AND BUSINESSMEN ARE ALREADY STRETCHED TO THEIR LIMITS AND AN OIL IMPORT FEE WOULD STEAL VALUABLE REVENUES.

BUT I WOULD LIKE TO GIVE SOME SEMBLENCE OF AN OPEN MIND. SO I WILL RAISE FOUR QUESTIONS WHICH MUST BE ASKED AS WE CONSIDER THESE PROPOSALS.

o WHAT DO WE WANT TO ACCOMPLISH WITH THIS TOOL? DEFICIT REDUCTION? REVENUE NEUTRAL TAX REFORM? OR PROTECT THE DOMESTIC OIL INDUSTRY?

o WHAT WILL IT DO TO OUR ECONOMY?

o WHAT AFFECT DO FALLING OIL PRICES HAVE ON IMPORT LEVELS AND U.S. LONG TERM ENERGY SECURITY?

o HOW WILL THIS AFFECT FOREIGN RELATIONS AND TRADE?

I LOOK FORWARD TO HEARING WHAT TODAY'S WITNESSES HAVE TO SAY. THANK YOU, MR. CHAIRMAN.

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STATEMENT OF HON. GARY HART, A U.S. SENATOR FROM THE STATE OF COLORADO

Senator HART. Mr. Chairman, thank you very much. In the immortal words of all politicians, I shall be brief.

About 8 or 9 years ago, I proposed an oil import fee. This was at a time when oil was selling, I think, at $40 or more per barrel: and I believe I was one of the first, if not the first, member of Congress to propose that we tax imported oil even at that level. The reason was not to help balance the Federal budget. The reason was not to help the domestic oil industry. The reason was not Gramm-Rudman. The reason in 1977 was the same reason that I think applies in 1986, and that is this country's national security.

So long as this country relies substantially on imported oil, particularly from the Persian Gulf, we are not a secure nation. Our reliance on imported oil, including from the Persian Gulf, increases as the price falls. Arguments can be made, economic and political, that this is to our advantage, that we ought to take maximum advantage of falling oil prices in the world marketplace and import all the oil we can. Now, that would be wonderful except for one problem; and that is we cannot guarantee a continued supply of that oil, nor can we guarantee its price. People say this is a wonderful bonanza for the United States. We don't have to pay for it. It doesn't cost us nearly as much as if we took some alternative steps: conservation, domestic production, and the rest. But the answer is we are paying for it, for something that began in the 1970's, that is almost never discussed these days, and it is called the Rapid Deployment Force. It is costing this country tens of billions of dollars a year, and its principal, if not its sole, purpose is to secure supplies of oil from that dangerous region of the world called the Persian Gulf. Our best estimates as to what the Rapid Deployment Force costs us are in the range of $30 to $40 billion. That is a pretty high price to pay for somebody else's oil.

There is also, if you will, a hidden cost. It is not a political cost, and it is not an economic cost; it is a human cost. I have said over and over again that the principal reason why I introduced an oil import fee some 8 or 9 years ago is that, as a father of a teenage son, I don't intend to see my son lose his life in an unnecessary war in the Persian Gulf for someone else's oil. That is the reason for an oil import fee. It isn't Gramm-Rudman. It isn't to balance the Federal budget. And it isn't to help out the oil drillers in Texas, and Oklahoma, and Louisiana, although it will do all those things. It is to prevent this country from becoming unnecessarily reliant on a supply and a commodity and a resource that we don't need to rely on and makes us less secure rather than more secure.

Now, if members of Congress in 1986 want to support an oil import fee, whether it is a flat $10 a barrel across the board fee, or one with differential for refined products, or one that floats up and down to stabilize the world market place, I could care less. But I think the time has come for members of Congress to face up to the basic point, and that is that it costs us to rely on other people's oil, and it may cost us in the most precious resource we have and that is human lives unless we sober up.

It appalls me as one member of Congress that the issue that dominated the public debate between 1974 and 1980 seems to have gone away. I cannot recall from this President one speech on the issue of energy, in 6 years; and yet, it is still a major question for this country. It is a question for our foreign policy. It is a question for our economic policy. And it is a fundamental issue about the direction of this country. We don't today have an energy policy. I wish we did. I think we can begin it here in this committee by imposing a fee on imported oil. Thank you very much.

Senator **Wallop**. All right. Thank you. I appreciate your taking the time to come down here and testify. And I know that you have proposed these fees in the past. I am not so good at reading tea leaves, but I think I can count votes; and I think we are probably still short.

Senator **Hart**. Let's keep trying.

Senator **Wallop**. Thank you very much.

Senator **Hart**. Thank you, Mr. Chairman.

Next is the statement from Mr. E. Allan Wendt, Deputy Assistant Secretary of State for International Energy and Resources Policy.

[The prepared written statement of Senator Hart follows:]

STATEMENT ON OIL IMPORT FEE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
SENATOR GARY HART
FEBRUARY 28, 1986

Gary Hart

I WANT TO THANK CHAIRMAN WALLOP FOR SCHEDULING THESE HEARINGS ON THIS ISSUE. FOR EIGHT YEARS, I HAVE URGED THE SENATE TO CONSIDER THIS POLICY. THE OIL IMPORT FEE BILL I PROPOSED LAST SUMMER, A BILL NOW BEFORE THIS COMMITTEE, IS THE THIRD SUCH BILL I HAVE OFFERED.

IN THE COURSE OF THESE HEARINGS, SOMEONE WILL PROBABLY CALL THE OIL IMPORT FEE AN IDEA WHOSE TIME HAS COME. OBVIOUSLY, I THINK ITS TIME HAS ALREADY BEEN HERE A WHILE. IT BEGAN WHEN WE LEARNED HOW DEPENDENT WE WERE ON FOREIGN SUPPLIERS OF OIL IN 1973. IT BECAME MORE INSISTENT WHEN WE HAD TO RELEARN THAT LESSON IN 1979.

IN THE 1980S, THE WORLD OIL MARKET HAS GRADUALLY TURNED AROUND. SUPPLY HAS STRENGTHENED, PRICES HAVE EASED. AND THE RECENTLY STEEP DESCENT IN PRICES HAS BROUGHT EUPHORIC HEADLINES AND A WIDESPREAD BELIEF THAT -- SUDDENLY, SOMEHOW -- OIL WILL BE CHEAP AND PLENTIFUL FOREVER.

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MR. CHAIRMAN, IF WE BELIEVE THIS, WE CONDEMN OURSELVES TO LEARNING THE HARD LESSONS OF DEPENDENCY ALL OVER AGAIN.

IN DECEMBER, THE DEPARTMENT OF ENERGY REPORTED THAT U.S. SUPPLIES OF OIL WOULD ATTENUATE IN THE 1990S -- MAKING US MORE DEPENDENT ON FOREIGN OIL. NOW, WE HAVE HEARD SUCH ALARMS BEFORE. BUT THIS REPORT ALSO SAID WORLD MARKET PRICES WOULD NOT BE HIGH ENOUGH TO DRIVE DOMESTIC EXPLORATION AND DEVELOPMENT. AS A RESULT, THE U.S. WILL ONCE AGAIN RELY ON FOREIGN POWERS FOR HALF ITS OIL OR MORE.

BUT THE NEWS GETS WORSE. THE DECEMBER REPORT ASSUMED PRICES THAT NOW SEEM A DISTANT MEMORY. PRICES HAVE SLID FARTHER AND FASTER THAN ANYONE FORESAW. AND THAT MEANS WE WILL DRILL FOR LESS, FIND LESS AND PUMP LESS OIL AT HOME THAN DOE HAD THOUGHT.

SO OUR NATIONAL CHOICE IS CLEAR. WE CAN ENJOY A VACATION AND BASK IN CHEAP ENERGY'S GLOW. BUT BY DOING SO, WE SENTENCE OURSELVES TO ANOTHER LONG SEMESTER IN THE SCHOOL OF HARD KNOCKS.

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Because when we depend once more on the cheapest supplies -- the foreign sources, the OPEC sources, the Persian Gulf sources -- we can once more be hog-tied by these suppliers.

We all know what those episodes in the 1970s cost our economy in growth, jobs, and competitiveness. Economists tell us the oil shocks led to a third or more of the worst peacetime inflation we have ever had.

But the truly chilling memory is that of America trapped in deadly circumstances without recourse. By relying on foreign powers for a vital resource, we gave them a weapon deadlier than any they could fashion on their own.

We became vulnerable to an ugly form of blackmail as foreign powers tried to drive a wedge between our nation and the State of Israel. Worse yet, the oil crisis demonstrated how close to the edge of national security we might be pushed in an all-out oil crisis.

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OUR BEST CHANCE TO CONTROL OUR CHRONIC CASE OF ENERGY DEPENDENCY IS TO ACT WHILE MARKET CONDITIONS ARE FAVORABLE. A $10 PER BARREL FEE ON IMPORTED OIL WOULD BE A LASTING BULWARK AGAINST VULNERABILITY AND DEPENDENCY. WHILE ACHIEVING ITS ENDS THROUGH THE ENERGY MARKET, IT WOULD DO FAR MORE FOR AMERICA THAN THE MARKET ALONE EVER COULD.

FOR TOO LONG, WE HAVE STOOD BY AND HOPED THE WORLD MARKET WOULD SERVE OUR NATIONAL GOALS. IN 1981, WE COMPLETED THE REMOVAL OF PRICE CONTROLS, AND FOR A TIME DOMESTIC SUPPLY IMPROVED. DRILLING INCREASED, AND SO DID SEISMIC EXPLORATION. WE GOT SERIOUS ABOUT SYNTHETIC FUELS AND MADE LONG OVERDUE PROGRESS IN FUEL CONVERSION AND CONSERVATION.

BUT AS HIGH PRICES AND A WORLD RECESSSION FORCED THE WORLD TO REDUCE OIL CONSUMPTION, AS PRODUCERS KEPT PUMPING MORE, PRICES BEGAN TO DECAY. THE INCENTIVE TO FIND DOMESTIC ENERGY WEAKENED. OUR GAINS IN SELF-RELIANCE LEVELED OFF.

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SYNFUELS LOST SUPPORT IN CONGRESS BECAUSE THEIR PRICE OF PRODUCTION NEVER BECAME COMPETITIVE IN THIS MARKET. DRILLING WANED BECAUSE ITS COST -- WHILE LOWER TODAY THAN FOUR YEARS AGO -- WAS UNDERCUT BY CHEAPER IMPORTS. AND THIS ADMINISTRATION HAS DISCARDED A VARIETY OF R&D PROGRAMS AND AFFIRMATIVE MEASURES -- SUCH AS APPLIANCE AND AUTO FUEL STANDARDS -- WHICH WOULD PROMOTE AND PRESERVE EFFECTIVE ENERGY CONSERVATION.

AS A RESULT, SINCE 1981, WE HAVE AGAIN USED MORE OIL EACH YEAR THAN WE DISCOVERED AT HOME. WE HAD MORE THAN 4,500 DRILLING RIGS AT WORK FOUR YEARS AGO. WE HAVE ONLY A THIRD AS MANY NOW, AND THE NUMBER HAS FALLEN FAST SINCE THE FIRST OF THE YEAR. SEISMIC EXPLORATION IS DOWN BY MORE THAN HALF. AND WE ARE ALREADY BACK TO RELYING ON IMPORTS FOR 30 PERCENT OF THE OIL WE NEED EVERY DAY.

THE POINT IS THIS: RELYING ON THE MARKET WORKED FOR A TIME, BUT THE WORLD ENERGY MARKET ULTIMATELY PLEDGES ALLEGIANCE TO NO FLAG. WE CANNOT RELY ON IT TO DEFINE OUR ENERGY STRATEGY OR DEFEND OUR NATIONAL INTERESTS.

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AS THE PETROLEUM MARKET CHANGES, WE MUST ALSO CHANGE OUR STRATEGY TO DEAL WITH IT. AND THE OIL MARKET IS NOW UNDERGOING THE MOST RADICAL CHANGES OF OUR ERA. FOR THE PAST FEW YEARS, I'VE BEEN WARNING PEOPLE ABOUT LISTENING TO THE LULLABY OF LOW PRICES. AND THAT WAS BEFORE WE SAW THREE PRECIPITOUS MONTHS WIPE OUT HALF THE VALUE OF BENCHMARK U.S. CRUDE ON THE FUTURES MARKET.

IF LOW PRICES WERE A LULLABY, PRICE DROPS OF THAT MAGNITUDE COULD BE A KNOCK-OUT DRUG. WHO CAN CARE ABOUT ENERGY SECURITY WHEN PRICES ARE FALLING AT THE PUMP? WHO CAN RESIST THE TEMPTATION OF SHORT-TERM ECONOMIC GAINS AND POLITICAL DIVIDENDS?

WE OUGHT TO RESIST THEM, MR. CHAIRMAN. WE OUGHT TO BE USING OPEC'S SEASON OF WEAKNESS TO PUT OUR FEET ON SOLID GROUND -- FOR NOW AND FOR THE 21ST CENTURY. THE OIL IMPORT FEE WOULD REVERSE THE CURRENT TREND TOWARD COMPLACENCY. RESEARCHERS FOR THE TEXAS RAILROAD COMMISSION ESTIMATED LAST YEAR THAT EVEN A $5 PER BARREL FEE COULD PUT 1,250 RIGS BACK IN THE FIELD -- AN INCREASE OF TWO-THIRDS OVER CURRENT DRILLING.

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IF, IN THE ALTERNATIVE, WE WAIT FOR THE NEXT CRISIS, WE WILL FIND THAT U.S. DRILLING RIGS HAVE LONG SINCE BEEN MOTHBALLED OR SHIPPED OVERSEAS.

THE TARIFF WOULD ALSO TAKE A HEALTHY BITE OUT OF ANOTHER THREAT TO OUR ECONOMIC WELL-BEING, THE MERCHANDISE TRADE DEFICIT. THAT FEVER BROKE THROUGH $100 BILLION IN 1984 AND KEPT CLIMBING LAST YEAR. NEARLY HALF OF THAT TRADE DEFICIT GOES TO PAY FOR FOREIGN PETROLEUM.

FOR AS LONG AS I'VE PROPOSED AN OIL FREEDOM FEE, I'VE SEEN IT AS ENERGY POLICY -- FIRST AND LAST. I HAVE PROPOSED THAT ITS REVENUE BE REBATED TO CONSUMERS TO OFFSET HIGHER ENERGY COSTS. BUT GRAMM-RUDMAN HAS LIMITED OUR ABILITY TO MAKE GOOD POLICY FOR THE RIGHT REASONS. NOW IT SEEMS WE MUST MAKE VIRTUALLY ALL POLICY FOR ONE REASON -- DEFICIT REDUCTION.

BUT IF THE NEED FOR DEFICIT REDUCTION IS NOW PRESSING ENOUGH TO JUSTIFY RETAINING THIS FEE'S REVENUE, IT IS ALSO THE ONLY NEED PRESSING ENOUGH TO DO SO.

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I WOULD NOT SUPPORT RETAINING THE FEE'S REVENUE TO FINANCE ANY NEW FEDERAL PROGRAMMING. NEITHER WOULD I SUPPORT ITS RETENTION TO GREASE PASSAGE OF TAX REFORM -- ESPECIALLY IF IT PAYS FOR RESTORING TAX BREAKS TO SPECIAL INTERESTS.

IN 1984, AS A CANDIDATE FOR PRESIDENT, I TOOK THE OIL IMPORT FEE ISSUE TO THE NORTHEAST, WHERE MANY FAMILIES HEAT THEIR HOMES WITH OIL. AND EVEN THOUGH AN OIL IMPORT FEE COULD MEAN HIGHER HEATING BILLS FOR SOME OF THEM, THE VOTERS IN THOSE STATES GAVE ME THEIR SUPPORT. THEY UNDERSTOOD THAT NATIONAL SECURITY IS THEIR SECURITY. AND THEY KNEW WELL THAT THEY WOUILD SUFFER THE WORST IF POLICYMAKERS ALLOW THE DAYS OF GAS LINES AND SOARING PRICES TO RETURN.

IN FACT, THE EFFECT OF THE FEE ON ALL CONSUMERS WOULD BE MINIMIZED IN THIS SEASON OF OVERSUPPLY. FOREIGN PRODUCERS WOULD BE FORCED TO BID AGAINST EACH OTHER TO SELL IN THE U.S. THE CONGRESSIONAL BUDGET OFFICE AND OTHER SORUCES -- SOME OF THEM UNFRIENDLY TO THE FEE -- HAVE ESTIMATED THAT PRODUCERS WILL ABSORB AS MUCH AS A THIRD OF IT THEMSELVES.

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MOREOVER, THE EFFECT OF THE FEE ON CONSUMERS WILL BE COUNTERBALANCED BY THE MARKET FORCES NOW TUGGING RETAIL PRICES DOWNWARD. RARELY HAS FARSIGHTED POLICY COME AT SUCH A MANAGEABLE COST.

SO WE HAVE A TREMENDOUS OPPORTUNITY TODAY. WE CAN STOP OUR DEPENDENCE ON FOREIGN POWERS FOR THIS MOST VITAL OF NATURAL RESOURCES.

WE CAN LIFT THE DEPRESSION NOW SETTLING OVER OUR DOMESTIC ENERGY SECTOR. WE CAN TAKE ADVANTAGE OF OPEC'S DISARRAY. WE CAN START DIGGING OURSELVES OUT OF THESE RUINOUS FEDERAL DEFICITS.

BUT WE MUST ACT NOW. WE CANNOT AFFORD TO WAIT UNTIL THE SAUDIS' LOW-PRICE STRATEGY DRIVES COMPETITORS FROM THE FIELD. WE MUST NOT WAIT UNTIL SOME THIRD WORLD DISRUPTION CUTS OFF OUR OIL AGAIN. WE MUST BRING THE STRENGTH WE ENJOY TODAY TO BEAR ON THE CHALLENGES WE WILL FACE TOMORROW.

STATEMENT OF E. ALLAN WENDT, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL ENERGY AND RESOURCES POLICY, ECONOMIC AND BUSINESS BUREAU, DEPARTMENT OF STATE, WASHINGTON, DC

Secretary WENDT. Thank you, Mr. Chairman, for the opportunity to appear today before the subcommittee to provide the views of the Department of State on the issue of possible oil import fees. Mr. Chairman, I have a brief summary of my written statement and, with your permission, I would like to provide that summary and then submit my full statement for the record.

Senator WALLOP. By all means.

Secretary WENDT. Mr. Chairman, the Reagan administration has pursued a market-oriented energy policy that we believe has strengthened our energy security and benefitted American consumers. We have urged other countries to pursue similar policies. We believe that an oil import fee would be a retreat from policies that have served us well and have contributed to lower prices and less reliance on potentially insecure sources of energy. We believe that an oil import fee would have significant negative effects on the competitive position of energy-intensive industries, on our trade relations, on our foreign policy, and on our energy security.

Let me say a word about competitiveness. The international competitiveness of our energy-intensive industries would be damaged through higher costs and penetration of markets by cheaper foreign products. I will cite two examples of important export-oriented industries that would be affected. One is petrochemicals which are already suffering from increased imports in the United States, and another is agriculture which is a major consumer of petroleum products and a very important export industry.

Mr. Chairman, we also believe that an oil import fee would pose significant problems under the GATT and other trade commitments. Under the GATT, our tariffs on most refined products are limited to present levels. Members of the GATT that would be affected by an oil import fee could demand compensation or retaliate against U.S. exports. Our tariffs on crude and fuel oils are bound under a bilateral agreement with Venezuela, which is not a member of the GATT; and GATT members could claim the same rate under most-favored-nation treatment. Even if we could justify an import fee on national security grounds under the GATT, and there is such a provision, injured members would still be entitled to compensation or retaliation. There are other significant problems that we see in an oil import fee.

Let me say a word about debtor nations. Oil exporting developing countries in financial difficulties, notably Mexico, would suffer a further drop in revenues. Unfriendly elements in the most severely affected countries could press for decisions to default on debt obligations. Neighbors and close allies such as Mexico, Canada, Venezuela, the United Kingdom, and Norway, which collectively account for over 50 percent of our oil imports, have all expressed opposition to an import fee. Last year in Quebec, President Reagan and Canadian Prime Minister Mulrooney agreed to reduce barriers to bilateral trade between the United States and Canada. An oil import fee would depart from this commitment.

The moderate Arab States are opposed to an import fee, and hostile governments, such as Libya and Iran, would attempt to use the fee against us for their own purposes. With regard to energy supplies, Mr. Chairman, an import fee to the extent that it lowered world prices, would discourage exploration and development in higher cost areas. Over time, this would favor Middle East producers. Lower world oil prices would also have a depressing effect on the price of natural gas, which is an alternative competing fuel. This, in turn, could threaten the development of major new energy sources such as natural gas from the giant Norwegian troll field which is the most important new indigenous natural gas reserve potentially available to Western Europe. The result could be reduced energy security in Western Europe.

Mr. Chairman, in July 1985 in the 21 member state International Energy Agency, there was a commitment reached at ministerial level that the member countries, including the United States, would maintain open markets for refined oil products or create open markets where they were not already open. We think an oil import fee would certainly be a retreat from that commitment. It would also be a retreat from the existing concensus in the International Energy Agency which the United States has worked hard to achieve in favor of letting market forces determine oil prices and production levels.

To conclude, Mr. Chairman, we think an oil import fee would be inconsistent with our efforts to promote market-based energy trade which we believe is in the long-term interests of both producing and consuming countries. We think such a fee would be contrary to the GATT and our other trade obligations and would weaken American industrial competitiveness in world markets. And finally, Mr. Chairman, we think that an oil import fee would aggravate the economic difficulties of a number of close allies and friendly countries. Thank you.

Senator **Wallop**. All of what you say apparently is on standby on the alter of tax reform. Is that correct?

Secretary **Wendt**. I am sorry, Mr. Chairman. I didn't hear what you asked.

Senator **Wallop**. All of what you say is basically on standby on the alter of tax reform. Whatever problems that you have identified in your statement would be easily surmounted if we needed it for a revenue-neutral tax reform?

Secretary **Wendt**. No, Mr. Chairman, I don't think that they would be. The purpose of my testimony this morning is to cite a number of disadvantages that we see in an oil import fee.

Senator **Wallop**. I understand that, but the one of the other hats of the administration came down yesterday and said despite a number of problems, that it was a worthy consideration in tax reform.

Secretary **Wendt**. Mr. Chairman, the President has said that he would consider an oil import fee in the context of a revenue neutral tax reform bill. I am well aware of that. I do not believe that my statement this morning is incompatible with that position. If there were an oil import fee, it does not mean there wouldn't be disadvantages to it. The President, the administration, would presumably weigh the advantages and disadvantages and make their decision. I am simply here citing what we perceive as significant disadvantages with regard to the foreign policy aspects of an oil import fee. I have not commented on the impact on the domestic economy nor——

Senator **Wallop**. Oh, I understand that; but these are, at least as I have read them—and I haven't read your whole statement—reasonably serious consequences.

Secretary **Wendt**. I would agree, Mr. Chairman, that they are reasonably serious consequences.

Senator **Wallop**. I guess the committee remains something at a loss as to which level of priority the administration places on things; I suppose that will show up as time passes. Would you explain to me how the State Department thinks this would lower world oil prices?

Secretary **Wendt**. In a weak oil market, and that is certainly what we have right now, the incidence of an oil import fee would tend to be shifted back to the producers. Our own imports would decrease to some extent.

Senator **Wallop**. That would be favorable then for our balance of trade, would it not?

Secretary **Wendt**. It would be favorable for our balance of trade perhaps in the short run, but over time it is just not clear that it would because the ripple effects of higher energy costs in the United States would affect other export industries, just as I indicated. I cited two examples.

Senator **Wallop**. How is it going to lower the price? For instance, in the formula that Senator Bentsen and I have designed, which plays off of a set price, are you suggesting that there is no bottom to what oil producers would think——

Secretary **Wendt**. What I am suggesting is that, to the extent that the United States took less oil off the world market, assuming oil exporting countries attempted to maintain market shares, they would be trying to export more oil. They would be trying to export the same quantity of oil; it would have to go somewhere else, and that would have a depressing effect on world oil prices. In other words, the demand the United States makes on the world oil market would decrease.

Senator **Wallop**. I have a big problem again. Is it our obligation to look to the economic welfare of OPEC?

Secretary **Wendt**. Senator, no, it is not our obligation to do that; and I don't think that there is anything in my testimony that suggests that that is our concern. Of our four largest suppliers, three are not even members of OPEC: Canada, Mexico, and the United Kingdom.

Senator **Wallop**. Mexico is a cooperating entity with OPEC, at least by their proclamation.

Secretary **Wendt**. Well, I can't really comment on that. The fact is they are not a member of OPEC.

Senator **Wallop**. I know they are not a member, but by their proclamation, they are cooperating as an entity with OPEC.

Secretary **Wendt**. At times, they have made statements to that effect, but certainly we consider Mexico a reliable supplier, just as we consider Canada and the United Kingdom reliable suppliers. They are not members of OPEC. The purpose of our policy is certainly not to strengthen OPEC. Our dependence on OPEC oil, as you know, has gone down considerably in the last several years.

Senator WALLOP. It is rising again, though.

Secretary WENDT. Yes, it may rise over time. If oil prices stay low, but——

Senator WALLOP. In the State Department thinking, is there a time when the net diplomatic and strategic power of the United States is damaged by the lack of a domestic capacity to produce energy?

Secretary WENDT. Mr. Chairman, that is a very theoretical question.

Senator WALLOP. It is not so theoretical if we are looking toward our national survival. Certainly, it is one which you must consider at some point.

Secretary WENDT. Certainly, one of our principal concerns is vulnerability to an oil supply disruption. We have taken steps to ensure that we are able to cope with an oil supply disruption. We have something like 493 million barrels of oil on our strategic petroleum oil reserve. The principal damage that would be inflicted on the United States in the event of an oil supply disruption would come from higher prices. Whether we import a lot of oil or whether we do not, if there were an oil supply disruption, we would be severely affected as we were——

Senator WALLOP. The military might have some effects, wouldn't it?

Secretary WENDT. The military?

Senator WALLOP. Yes. Couldn't it be damaged in the event of a world crisis by an oil supply disruption? We don't have very many coal-fired airplanes.

Secretary WENDT. Well, of course, in the event of a major oil supply disruption, not just the military, any consumer of oil would be——

Senator WALLOP. But that is just my point. At what point does this enter into the consideration of the thinking of the State Department?

Secretary WENDT. It enters into the thinking of the State Department at all times, Mr. Chairman. I don't think we have ever lost sight of it, and I believe that the administration has pursued policies that have strengthened our energy security and not decreased it.

Senator WALLOP. What about this new negotiated arrangement with the International Energy Agency of which you speak, the question of the 1985 refined products. I haven't heard of that. Is that something that we must ratify? Just what is that?

Secretary WENDT. No, sir. That is a declaration. It is not a binding legal commitment. It was a communique issued by the agency.

Senator WALLOP. Who negotiated that? The Department of Energy or the Department of State?

Secretary WENDT. We were all involved in it. Secretary Harrington was the U.S. representative; and as I said, it is not a legally binding commitment. It doesn't require any kind of ratification. It is not a treaty. But the point is, if we were to walk away from that commitment, I don't think it would do much for our credibility in the organization. We worked hard to achieve it, and the reason we

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did was because there was great concern that, with new refineries coming onstream in the Middle East, if some markets were closed, those new products would go to the markets that were open. Our market is open. The markets of most Western European countries are open. Japan, on the other hand, was not importing certain refined products like gasoline. We thought that the best way to solve the problem of growing exports of refined products was to ensure that markets are kept open. That way, the products would flow on the basis of market forces and wouldn't inundate any one market.

Senator **Wallop**. Yes, but you know the greatest world market for refined products is here. I can't imagine you would have much trouble forcing that on OPEC and other people. It is to their advantage, and a genuine threat—a strategic threat—to domestic refining industry. They have requirements and standards in this country which do not exist anywhere in the rest of the world; and their situation is not only enormously constrained by taxes and the lack of energy policy, but as well by a very stringent set of environmental standards which don't exist anywhere else. What level of thinking went into the negotiation of that policy that tried to find some survival possibility for the American refining industry?

Secretary **Wendt**. Mr. Chairman, our thinking was that, if our market remained open and other markets remained closed, that wasn't going to be helpful to the American refiners. So, we think that this commitment, this agreement worked very definitely to their advantage. Japan, as a result of this agreement, is now importing gasoline. Prior to the agreement, it wasn't. It is now importing something like 36,000 barrels a day, which may not seem like a lot, but our hope is that that will grow. Anyway, they have begun to import gasoline.

Senator **Wallop**. One can always hope with the Japanese, but one ought not to hold one's breath.

Secretary **Wendt**. Well, it is a start.

Senator **Wallop**. So is—what is it? 140,000 pounds of beef, or something like that? It is a start, but nothing has ever grown from it. My guess is, and my concern is, that what we will see is that this remains the open market and we are bound by a commitment not to interfere with refined products in any way. And the only real detriment will settle on the domestic refining industry.

Secretary **Wendt**. Mr. Chairman, we are very concerned about making sure that this commitment is lived up to; and every time we meet in the International Energy Agency, we look at it and we are monitoring what is happening. And I can assure you that we will take every possible step to ensure that it is lived up to.

Senator **Wallop**. Mr. Wendt, thank you. I appreciate your coming here this morning.

Secretary **Wendt**. Thank you, Mr. Chairman.

Next is a panel consisting of Dr. Daniel Yergin, who is no stranger to conversations about energy policy and energy taxes; Dr. Bernard Weinstein, director of the center for enterprising at the Edwin Cox School of Business at SMU; and Dr. Charles Ebinger, director of energy and strategic resources at CSIS at Georgetown University. Gentlemen, welcome. Dr. Yergin, it is nice to see you again, sir.

[The prepared written statement of Secretary Wendt follows:]

Statement of E. Allan Wendt

Deputy Assistant Secretary of State

for International Energy and Resources Policy

Before the
Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation

February 28, 1986

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear today to express the views of the Department of State on the issue of possible import fees on crude oil and petroleum products. I will confine my comments to the various foreign policy implications of such import fees, and defer to others on other aspects of the issue.

Introduction

From the outset the Reagan Administration has pursued a market-oriented energy policy that has greatly benefitted consumers at home with lower oil prices and led to dramatic improvements in our energy security. Abroad, we have consistently urged others to pursue similar free market energy production and trade policies. Recent steps toward a market sensitive energy trade policy have been taken by Canada, Japan, and the European Community.

Since the first oil price shock, the United States has diversified its sources of supply for crude oil and petroleum products and greatly reduced its dependence on OPEC suppliers and on the Middle East in general. This development is reflected in the latest Department of Energy statistics, which show that the U.S. imports from the Middle East have fallen from 33% of total imports in 1981 to less than ten percent in the first 11 months of 1985. Similarly, OPEC's share of total

U.S. oil imports has dropped from almost 60 percent in 1981, to about 36 percent today.

Our three largest suppliers of petroleum -- Mexico, Canada and Venezuela -- are all in the Western Hemisphere. In the first eleven months of 1985 they accounted for 46.5 percent -- almost half -- of our total oil imports. Saudi Arabia, our number two supplier in 1981, is now ranked only eighth among U.S. suppliers.

An oil import fee raises a number of international issues.

GATT and Other Trade Obligations

An import fee on crude oil and refined petroleum products may pose difficulties under the General Agreement on Trade and Tariffs. U.S. tariffs on many petroleum products are bound at the current levels. Increasing the duties on those products -- such as motor fuel, kerosene, and naphthas -- would be inconsistent with our obligations under the GATT, unless it were justified under the GATT exception for measures necessary to protect our essential security interests. Even were a judgment made that imposition of an import fee was justifiable as such a measure, adversely affected GATT members which suffer demonstrable injury would be entitled to compensation or retaliation. U.S. exports to those member countries could suffer as a result.

Although the U.S. tariff on crude oil is not bound under the GATT, the U.S. has granted tariff rate concessions on crude, crude shale oil and distillate and residual fuel oils in a bilateral agreement with Venezuela. Raising the tariff on crude oil or imposing an import fee would be contrary to that agreement, unless it were justified under that agreement's exception for measures "relating to public security, or imposed for the protection of the country's essential interests in time of ... national emergency."

Exempting only Venezuela from higher tariffs would violate our obligation to afford most-favored nation (MFN) treatment to countries such as Canada, the United Kingdom, Nigeria and Indonesia, GATT members who are among our principal suppliers of petroleum. We also have bilateral treaties granting MFN treatment to suppliers who are not parties to the GATT. There may be no GATT-compatible way to exempt only a few foreign suppliers from an import fee. At current import levels, exempting Canada, Mexico, Venezuela, and U.K. -- and we would be under strong pressure to do so -- would gut the revenue impact by over 50 percent.

Effect on Competitiveness of U.S. Industry

While discussing the trade implications of an import fee, I should also note that an import fee would damage the international competitiveness of energy-intensive U.S. industries. In particular, such a fee could injure our domestic petrochemical industry. For 1985, shipments of the U.S. petrochemical industry were about $88.5 billion, with exports amounting to about $ 11 billion of that total. Increasing the cost of petroleum feedstocks would undermine the competitiveness of this industry, which is already faced with increased imports into the U.S. and deep penetration of its traditional export markets by new low-cost petrochemical plants in oil-exporting countries. American agriculture -- a significant consumer of petroleum through tractor fuel, fertilizers, crop drying and transportation to foreign and domestic markets -- would also be hurt by an increase in its costs and made less competitive in its important export markets. Injured industries would be certain to pressure the Administration for exemption or protection, which could lead to a rising cycle of protective measures and retaliation by our major trading partners.

Impact on High Debt Oil Exporters

In today's soft oil market, an oil import fee might be only partially absorbed by U.S. consumers, with the remainder being absorbed by foreign suppliers accepting lower prices in a struggle to maintain sales in the face of weak demand. The fee would also artificially maintain U.S. production and reduce U.S. imports. To the extent that an import fee succeeds in lowering international prices, the result would be a further drop in revenue, creating further problems for countries already in serious financial difficulty. The impact would be especially severe on Mexico, a country whose progress and development is important to us. Other countries seriously affected would include Peru, Ecuador, Venezuela, Nigeria, Egypt, and Indonesia. While an import fee might help regional banks with loans to domestic producers and the related service sector, it would adversely affect large money center banks with loans to exporting countries.

An import tax could strengthen the hand of unfriendly elements in key developing countries and could help trigger decisions to default on debt obligations. We would be accused of using an oil import tax to solve our domestic deficit or tax reform problems at the expense of others.

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Impact on U.S. International Relations

A new import tax would set back relations with our neighbors and our closest allies, some of whom have appealed to us not to adopt an import fee. The Canadian and Mexican governments have already expressed their strong concern about an oil import fee. Exempting these neighbors, however, would discriminate against our third and fourth largest suppliers, Venezuela and the United Kingdom. Officials of the Venezuelan government have also recently expressed concern about possible fees, and it is important to remember that Venezuela did not participate in the 1973 oil embargo. The UK, which has steadfastly refused to cooperate with OPEC on fixing prices artificially, also opposes the fee. Last year Prime Minister Thatcher personally expressed concern to President Reagan on the issue; and earlier this week, the Prime Minister of Norway, a close NATO ally that has also rejected cooperation with OPEC, issued a statement registering similar concern.

On a related note, at the Summit meeting in Quebec on March 18, 1985, President Reagan and Canadian Prime Minister Mulroney agreed to reduce barriers to energy trade between the U.S. and Canada. An import fee would be a retreat from this commitment.

Moderate Arab states have voiced their opposition to an import fee. Some have gone so far as to indicate it would be viewed as an "unfriendly act". Hostile governments, such as Iran and Libya, would attempt to use an oil import fee against us, arguing that the U.S. engineered the oil price collapse, intending to reap its benefits.

Future Energy Suppliers

An import tax, while encouraging U.S. production, in the short run would -- to the extent it lowered world oil prices, discourage development of higher-cost non-OPEC oil, thus favoring low cost Middle East producers in the longer term. Development of higher cost oil and gas reserves in the North Sea and the Canadian Arctic would be delayed and heavily import-dependent allies -- most notably Italy, the FRG and Japan -- would come to rely increasingly on OPEC, making them more vulnerable to a supply disruption in the future. Already the development of the Norwegian Hod and Snorre fields in the North Sea is being delayed. An import fee that pushed down world oil prices further would also depress natural gas prices in Europe because of the direct price links between these two fuels. Lower gas prices could threaten the development of the relatively high-cost giant Norwegian Troll natural gas field, which is the most important new indigenous natural gas reserve

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potentially available in Western Europe. If the Troll field is not developed, our West European countries may be forced to increase further their dependence on natural gas imports from the Soviet Union.

IEA Commitments

The 21-member state International Energy Agency (IEA) was created in 1974 with the objective of strengthening the energy security of energy-importing industrialized countries through international cooperation. Main goals of the organization have been:

- to coordinate long-term policies in order to reduce oil import dependence,

- to cooperate in the event of major oil supply disruptions.

At an IEA Ministerial meeting in July 1985, the U.S. successfully pushed for communique language calling for market-based trade in oil products. Since that time, Japan has moved to open its market, thereby reducing the chances that the current global excess in refining capacity might lead to increased protectionist pressures in other major consuming countries. France, Spain and Greece have also taken steps toward more open oil product markets. Imposition at this time of an import tax on crude and products would be a retreat from our commitment to keep oil product trade open. It might well trigger similar actions by our IEA partners seeking to shelter their own domestic oil industries, thus magnifying downward pressure on oil prices as well as creating additional trade problems.

Finally, an oil import fee would also be incompatible with the entire thrust of our approach to energy trade over the past five years in the IEA. This approach was reaffirmed at a recent meeting of the IEA Governing Board, where there was a strong consensus in favor of continuing to let market forces determine oil prices and production levels, and against the imposition of import fees. That consensus would be undermined, to the detriment of our energy security and economic interests, if the United States were to break ranks and attempt to protect its own producers at the expense of others.

STATEMENT OF DANIEL H. YERGIN, PH.D., PRESIDENT, CAMBRIDGE ENERGY RESEARCH ASSOCIATION, CAMBRIDGE, MA

Dr. **Yergin**. Thank you, Mr. Chairman. I want to thank you and the committee very much for the invitation to participate in the hearing this morning. I will just briefly summarize my testimony.

The issue that the committee is addressing, an oil import fee, stands at the intersection of four major concerns: Energy policy, trade policy, revenues and the deficit, and overall economic growth. And the vigor of yesterday's discussions and this morning's attest to the significance of those issues. I would like to just touch on, one, the state of the oil market; two, some of the questions and considerations raised by an oil import fee; and three, some of the international perspectives. I think Senator Moynihan earlier this morning spoke about semantic infiltration, and maybe there was some of that in the discussion this morning because, of course, the issue under discussion is not the question of rising oil prices, but really the question of the extent to which they fall. And Senator Chafee earlier raised a question about the extent to which they have fallen when you correct for inflation; and I was just checking over those numbers; and basically, with an average oil price of $18 a barrel, we are back to 1974 in real terms in terms of oil prices. What this tells us is that the balance of power in the world oil market has shifted dramatically back from sellers to buyers. Oil prices have given way to oil wars, and the fall in oil prices constitutes a massive shift in political and economic power.

If we look on an annual basis at a price of $18 a barrel, we are seeing a shift from one side of the table to another of around $60 billion; and we are also seeing a $15 billion fall in the U.S. trade deficit. This kind of shift constitutes a very large stimulus to economic growth and to lower inflation. It is like a very large tax cut with the blessing that it doesn't add to the deficit, and it brings large economic benefits to many people. Of course, it also brings some significant dangers: to the economic viability of the American oil and gas industry; to a number of countries, some of whom are of prime importance to the United States; possibly to a financial system that adapted too well to the shock of rising oil prices; and possibly to the longer term enery security of the United States, a subject that has for the time being fallen off the table.

Just a point, to say that really the system worked. We paid a high price for the oil shocks in terms of recession and inflation, but then we got a very strong response by consumers intermingled with policy; and the result today is that we see OPEC has been forced into its oil war. While these lower prices have very positive overall economic benefits, they also point to specific problems coming in the energy area. Prices below $15 a barrel could shut in up to 10 percent of U.S. oil production. Prices at that level for a protracted period of time would certainly put a freeze on much new exploration activity, and prices at that level could mean 700,000 barrels a day less oil produced in the North Sea by 1992 than would be the case at $23 a barrel.

With these kind of conflicting perspectives which we have already heard this morning, the committee is really facing three questions: To what degree will lower prices cripple the U.S. domestic oil and gas industry in terms of the ability to produce, to invest, to replace reserves, and to stay in business? To what degree will lower prices shift dependence back to an unstable part of the world by choking off new oil and nonoil development and undercutting conservation? And to what degree is the financial system vulnerable to collapsed prices and how can that situation be ameliorated? Let me just take a couple more minutes to, one, summarize the arguments for and against the tariff or fee, and then to talk about the international perspectives which go back to what you were discussing before.

Basically, the protection, in terms of protecting the industry, is a question about rising imports in the future and what type of price we will pay. Obviously, the second issue has been the question of revenue gains. The arguments against the tariff focus on losses to consumers and also the bureaucratic and administrative difficulties and the foreign policy issues. And in that area, rather than going through the separate points, we should note in the case of the U.S. manufacturing industries, on one hand: they would be hurt; on the other hand, they have been helped by the fall in the value of the dollar. Is that time?

Senator WALLOP. Yes, but I would like to hear your summary.

Dr. YERGIN. Fine. Let me take jist one last minute to say: How would other international actors respond to a tariff or an oil import fee on the part of the United States? Other Western Hemisphere countries would be very concerned by a U.S. tariff that did not include an exception to tie them in. This takes on special importance for Mexico in its difficult circumstance. The North Sea producers, Britain and Norway, would argue that the Western Hemisphere should extend as far aa the North Sea and that in some fashion they should be included, or they would lobby against it. A major concern that has come up in these discussions has been whether Japan would gain a new trade advantage from a U.S. import fee because of the cost advantage that Japanese manufacturers would gain. However, there is discussion within Japan that the Japanese might well put on an oil import fee of their own if the United States did in order to protect their heavy investment in energy diversification and to generate revenues. I think that is not well known here. The various Western countries would argue that the United States should consider a coordinated floor price through the machinery of the International Energy Agency. Many of them are now looking at additional excise taxes on oil. Oil exporters in general would fear that, as in the last discussion, lower prices in the world market would result from a U.S. fee. For the OPEC countries, a U.S. tariff means a transfer back to the U.S. Treasury from their own of the rents on their oil. And ironically, we can be sure that the prospects of such a tariff, even as being discussed today, will be one of the stronger arguments among them for settling what are now their very strong differences. Now, why don't I stop there?

Senator WALLOP. Thank you, Dr. Yergin. I have no questions for you. Dr. Weinstein?

[The prepared written statement of Dr. Yergin follows:]

TESTIMONY

presented to the

SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

by Dr. Daniel Yergin

President, Cambridge Energy Research Associates

February 28, 1986

I wish to thank the Committee for this invitation and opportunity to join in its hearings this morning. The issue that this Committee is addressing -- an oil import fee -- stands at the intersection of four major concerns -- energy policy, trade policy, revenues and the deficit, and overall economic growth.

In my testimony this morning, I will approach this issue from two points:

- State of the oil market. How the oil market arrived at its current position, the perspectives of different actors, and possible further developments.

- Questions raised by an oil import fee, suggesting some of the issues raised by consideration of an oil import fee, and possible consequences.

I. The Gains

Let me begin by observing how the oil market has come half circle from the events of the late 1970s. The balance of power in the world oil market has shifted dramatically back from sellers to buyers. Oil crisis has given way to "oil wars." The fall in oil prices constitutes a massive shift in political and economic power.

The process did not begin in December, 1985. Between 1981 and the autumn of 1985, the real price of oil to the American consumer fell by about 40 percent. In the last three months, the dollar price has fallen by $8-9 a barrel. Spot prices registered an even larger fall -- $13-14 a barrel. The effects of 1973 and 1979-1981 have been put sharply in reverse.

So many different kinds of oil prices are being cited that it is no easy thing to know what the average traded price of oil worldwide is today. We believe that it could currently be as low as $18 a barrel. If that is the case, then, on an annualized basis, this amounts to a shift of $60 billion from one side of the table to the other -- that is, oil importers will pay $60 billion less to oil exporters. (It also means about $15 billion reduction in the U.S. trade deficit.) This kind of shift constitutes a very large stimulus to economic growth and to lower inflation. It could promote an OECD economic boom. It is similar to a tax cut in its effects, with the additional blessing of not adding to the Federal deficit. In short, the oil price fall brings large economic benefits to many people.

But such a change also has some dangers -- to the economic viability of the American oil and gas industry; to a number of countries, some of whom are of prime importance to the United States; possibly to the financial system that adapted too well to the shock of rising oil prices; and possibly to the longer-term energy security of the United States -- a subject that has, for obvious and understandable reasons, fallen off the table for the time being.

II. The System Worked

The oil shock of 1973 arose from political conflict overlaid on top of economic fundamentals -- the rapid growth of oil consumption, which resulted in demand bumping up against the limits of what was then the available supply. The shock of 1979-81 reinforced this development, although psychology -- panic -- and uncertainty played a more important role than in 1973. The costs of the two oil shocks were heavy; they were measured in terms of inflation, recession, and unemployment. Ironically, the last to suffer from the consequences of 1979-81 are those nations that bet their economies on continually rising oil prices.

There was a broad and deep response to the oil world of the 1970s on the part of consumers and on the part of governments. The response took the form of conservation, substitution of other energy sources, and the development of non-OPEC oil.

People responded to price signals, but it was not perceptions of price alone that drove the response. For, intertwined with concerns about price, were perceptions and expectations about the insecurity of dependence upon oil. Governments in Western Europe and Japan, for instance, pushed the conversion of electricity generation away from oil to coal and nuclear. In this country, legislation pushed forward automobile fuel efficiency.

The result was that OPEC found its role in world energy and world oil markets shrinking. The underlying change in demand was camouflaged by the recession of the early 1980s. The world oil market itself was smaller. Free world oil demand in 1984 was about where it had been in 1972. The United States economy grew by a third between 1973 and 1985; yet in 1985, U.S. energy demand was no higher than in 1973, and oil demand was actually 10 percent lower.

The surge in non-OPEC oil came in the later 1970s and early 1980s, with the arrival in the marketplace of Alaskan North Slope, North Sea, and major new Mexican supplies. But non-OPEC has continued to grow since, and substantially so. The simple "rule" to date has been that non-OPEC oil gets produced at full throttle, while OPEC cuts back production to maintain prices - or, to put it more correctly, slows the retreat in prices. Thus, in 1979, OPEC produced 31 million barrels per day; by 1985, it was producing only slightly more than half that amount, about 16 mbd -- bringing it back to its production level of 1966.

OPEC's shrinking market share is shown by the following table:

OPEC's Shrinking Share
(million barrels per day)

	1983	1984	1985	1986
Free World Oil Demand	45.0	46.1	45.5	45.5
Non-OPEC Supply	26.2	27.5	28.3	28.7
OPEC NGLs	1.2	1.3	1.3	1.2
OPEC Crude	17.3	17.1	15.9	15.8
Inventory From/(To)	0.3	(0.1)	(0.0)	(0.2)

Source: Cambridge Energy Research Associates, World Oil Watch, Winter, Spring 1986.

III. The Struggle for Market Share

OPEC, however, on December 9, 1985, announced its rejection of the role of residual supplier. Instead, it declared that it was going to insist upon a certain market share -- still undefined, at least up to this point. It is currently functioning as what might be called a very "messy oligopoly."* The price collapse has followed, reflecting the realities of a 10-12 million barrel a day surplus of capacity over demand in the world oil market.

At the same time, these present circumstances reflect the way certain actors in the oil market have chosen to respond to the economic fundamentals. That takes us back to the spring and summer of last year, when Saudi Arabia and other Arabian/Persian Gulf producers decided that they would no longer accept the shrinking market being pushed upon them by the growth of non-OPEC production and by price cutting and cheating by other OPEC countries. They decided to win back market share -- both within OPEC and between OPEC and non-OPEC. They also concluded that falling prices would slow down conservation and the substitution movement away from oil, and stimulate renewed oil demand in the future. They believed that they could slow down the development of new higher-cost energy sources, both oil and non-oil.

Thus, today, we can observe an "oil war" -- among OPEC producers, between OPEC and non-OPEC countries, and oil and other energy forms. If the OPEC producers manage to revive their "messy oligopoly" and seek to make a relatively modest claim on market share -- say 17 mbd or below -- then we will likely see oil prices stabilize at prices higher than recent spot and futures prices. If not, the lower prices could last for a longer period. In any case, we should expect continuing volatility. The virtual certainty of continuing volatility makes it more difficult to address the policy issues raised by the oil price collapse, and is an argument against haste in coming to a firm conclusion as to what the appropriate response, if any, should be.

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*Cambridge Energy Research Associates, "Oil: Lessons and Non-Lessons from Other Commodities."

IV. The Costs

But the lower prices will have major effects. Let me give three examples:

- Prices below $15 a barrel could shut-in up to 10 percent of U.S. oil production -- up to one million barrels per day.
- Prices at that level for a protracted period of time could certainly put a freeze on much new exploration activity aimed at replacing oil and gas reserves -- especially on the part of the independent sector.
- Although lower prices would not have any immediate effects on production levels in the North Sea, by 1992, production in the

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British sector of the North Sea might be 400,000 b/d lower than it would be at $23.*

We see lower prices having a greater effect on supplies by the end of the decade than on demand, because much of the conservation and demand patterns appear to be locked in.

Who gets hurt by the low prices? The three problem areas are:

- The energy industries;
- Parts of the domestic banking system;
- Some of the major debtor countries, amongst whom Mexico looms the largest.

Thus, this Committee is really asking three questions:

- To what degree will lower prices cripple the domestic U.S. oil and gas industry, in terms of its ability to produce, to invest, to replace reserves -- and to stay in business?
- To what degree will lower prices shift dependence back to an unstable part of the world, by choking off new oil and non-oil development and undercutting conservation?

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*Cambridge Energy Research Associates, "A North Sea Shutdown? - Never!"

- To what degree is the financial system vulnerable to collapsed prices, and how can that situation be ameliorated?

Thus, we see that there are pressing economic questions at stake, as well as longer-term energy security questions. Energy security -- oil security -- was not a subject invented in October, 1973. Periodically such considerations have come to the fore -- going back as far as the first decade of this century. The general view since 1973 is that diversification is to be encouraged and applauded, although such efforts should have solid economic rationale -- in other words, not at any cost.

Today, energy security seems of very slight concern -- and with good reason. After all, Iran and Iraq are locked in deadly and massive combat, and the price of oil collapses. But can any of us speak with total confidence as to what the oil world of the 1990s will look like? Can one be absolutely confident that the Iran-Iraq War will not suddenly affect supplies temporarily -- next month or next week? As some of the members of the Committee know, CERA did a study with Arthur Andersen & Co. entitled The Future of Oil Prices: The Perils of Prophecy.* We found that from the early 1970s until the end of 1984, there were a succession of five different very strong consensuses -- we called them "vintages" -- throughout the world on the likely course of oil prices. Fourteen months ago, almost everybody believed Vintage 5 -- that oil prices would gradually decline through the early 1990s and then begin to increase.

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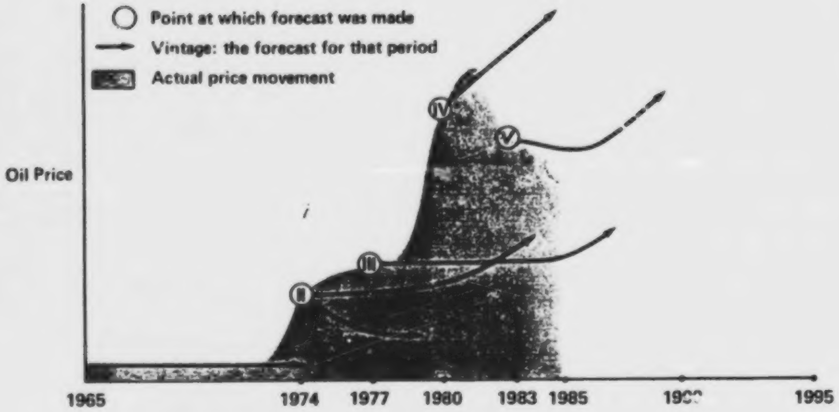
*Arthur Andersen & Co. and Cambridge Energy Research Associates, The Future of Oil Prices: The Perils of Prophecy.

The Five Vintages: An Overview



In the last two months, we have seen that vintage collapse. At this point, in the midst of all this turmoil, we would do well to be skeptical of anybody who said they could tell us with great confidence where oil prices will be in 1992 or 1993. At very low prices over the next few years, however, as already suggested, oil and gas exploration activity could be much lower, and those who lost market share in the first half of the 1980s could well regain it. It may well be their intention to seek a longer-term stable market, but power and influence can shift into other hands in the future.

V. The Arguments

Let us now specifically identify the key arguments for and against an oil import fee.

The major arguments in favor of such a fee are:

- The fee would protect and preserve the domestic U.S. oil and gas producing industry in a time of lower prices -- prices that may not give a good signal about longer-term developments.
- Without some such protection, U.S. imports would start growing again -- with major effects on the U.S. balance of trade as well as the U.S. energy position.
- Such a fee would protect the asset value of the energy loans of a large number of banks, so bolstering the banking system.
- A fee would establish a framework for continuing conservation and non-oil energy investment.
- Some floor may be necessary to keep the U.S. from becoming excessively vulnerable in the future.
- A fee would not mean rising prices to consumers -- rather, that some part of the fall in oil prices is shared by consumers with the U.S. Treasury.

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- Finally, but not inconsequential by any means, an oil import fee would raise revenues. A ten dollar barrel fee on all U.S. oil imports would raise $18-19 billion.

Four options can be identified for protecting the U.S. oil industry:

- Fixed rate tariff
- Variable rate tariff
- Percentage tariff
- Quota

As our colleague, Professor Robert Dohner, has observed, "All oil import tariffs, fees, or other restraint policies work by doing the same thing; they drive a wedge between domestic prices for crude oil and products, and their respective world market prices. But the policies differ in the form that this wedge takes, and each has its own economic and market characteristics."* Those whose primary concerns focus on the energy area may favor a variable rate tariff -- which, in effect, establishes a floor price for U.S. oil. Those whose primary concern is to raise revenues will tend toward the fixed rate tariff, thus assuring the revenue stream even if prices rise again.

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*Cambridge Energy Research Associates, "U.S. Tariffs and World Oil: Part One: Falling Prices, Budget Deficits, and the Tariff."

The arguments raised against a tariff include:

- Intervention served little purpose and created many problems in the 1970s, and the U.S. does better to accept the dictates of the free market. Various tariff proposals could also call forth again bureaucratic and administrative complexity.

- Exceptions might well have to be provided for Western Hemisphere countries with whom we have important political and economic relationships -- primarily Canada and Mexico, but also Venezuela and Ecuador. Last year, the U.S. imported about 45 percent of its oil from these countries. Thus, a Western Hemisphere exception cuts the revenues in half. Better, some say, to deal directly with the Mexican debt problem rather than try to solve it through oil prices.

- Domestic refiners that depend on imported oil and others would also seek exceptions.

- If the goal is revenue raising, a broader tax, such as a gasoline tax, could accomplish the same objectives with less administrative difficulties.

- A U.S. oil import fee will lead to lower prices on the world market and thus stifle new oil development elsewhere -- not necessarily good for U.S. energy security.

- o An oil import fee could loom as a very large piece of protection at a time when world trade issues are tense enough.
- o An oil import fee would hurt the competitive position of such energy-intensive U.S. manufacturing industries as petrochemicals -- although the fall in the value of the dollar has given such industries signficant help recently.

VI. The Perspectives of Other Actors

Over the last few years, one could have observed that other nations are more convinced than has been the customary view in this country that the U.S. would turn to a tariff or an import fee to protect the U.S. domestic oil and gas industry during a collapse. For one thing, the U.S. government has over the years intervened several times to protect the industry -- well before anybody ever heard of the Texas Railroad Commission. For instance, in the early 1890s, there was the prospect that cheap oil from Peru would flow into California, stunting the infant oil industry there. Before that could happen, the duty on imported oil was doubled, and the industry certainly thrived there.

How would other international actors respond to a tariff or oil import fee?

Other Western Hemisphere countries would be very concerned by a U.S. tariff that did not include an exception to tie them in. This takes on special importance for Mexico in its very difficult circumstances.

The North Sea producers -- Britain and Norway -- would lobby against a U.S. tariff. In 1985, Britain sold over 300,000 barrels a day to the U.S. If excluded, Britain and Norway might shift from their own non-intervention position on production.

A major concern has been whether Japan would gain a new trade advantage from a U.S. import fee because of the cost advantage that Japanese manufacturers would gain. However, there is discussion within Japan that the Japanese might put on an oil import fee of their own if the U.S. did, in order to protect their heavy investment in energy diversification and to generate revenues.

Various Western countries would argue that the U.S. should consider a coordinated floor price through the machinery of the International Energy Agency.

For the OPEC countries, a U.S. tariff means a transfer back to the U.S. Treasury from their own of the rents on their oil; and we can be sure that the prospects of such a tariff will be one of the strong arguments among them for settling their differences.

VII. Key Issues

Right now a high-stakes poker game is going on in the world oil market. Expectations have certainly been changed, but pressures are mounting on various participants, and we could see further surprises.

Whether we are looking at $15 a barrel oil in June, or $22, is highly uncertain. It is very important that the question on the table be raised now, and thought through. We have some time. In particular, I think the Committee can very valuably look further into:

- what effects the lower oil prices are likely to have on the U.S. oil and gas industry;
- the effects on the banking system;
- to assess, as Senator Wallop suggested last December, what would be the appropriate trigger level for a variable tariff.

In addition, of course, this Committee will no doubt continue to also look at this question in the context of the inescapable debate over revenues and the deficit.

STATEMENT OF BERNARD L. WEINSTEIN, PH.D., DIRECTOR, CENTER FOR ENTERPRISING, EDWIN L. COS SCHOOL OF BUSINESS, SOUTHERN METHODIST UNIVERSITY, DALLAS, TX

Dr. **Weinstein.** Thank you. I would first like to thank you for the invitation to be here today. Second, I would like to state a couple of facts that I think have been either misstated or misconstrued from what I have heard this morning. In the first place, I think it is important to understand that during the 1970's when we had that huge rise in prices, all we really did in the lower 48 States was slow down the rate of production decline. It took a 300 percent increase in drilling activity to bring that about.

A lot has been said this morning about how the Northeast and Midwest would bear a disproportionate share of an oil import fee's costs; and I am not convinced that is supported by the data. Information from the Department of Energy suggests that if you compare energy outlays as a percent of personal income, there is very little variation among regions, with the exception of the far West. In the Northeast, it is 10.3 percent; in the South, it is 10.2 percent. In the Midwest, it is 11 percent. Only in the far West is it significantly less, 8.1 percent; and I presume that has to do with the fact that there is a lot of hydropower available in that region.

A third point I would make is that we have heard a lot of talk about a free market for oil. There has never been a free market for oil. The oil markets have always been subjected to governmental intervention. $14 is not a market price any more than $35 was a market price a few years ago. The oil industry has been in the throes of a major structural change for the last 5 or 6 years. We have seen a declining number of players, both on the production side and on the refining side.

This structural change in the oil industry, which has been brought about through international competition and other factors, has been exacerbated by the recent precipitous drop in oil prices. Remember, it took 5 years for the price to drop from $35 to $27 and only 2 months to slide from $27 to $16. So, that is a 60 percent price drop in 5 years, and a 40 percent price drop in 2 months; and this, Senator Wallop, I submit is not a free market. It is reflecting panic selling. It is reflecting governmental interventions. And I don't think it is fair to talk about the currently depressed price in any way reflecting a market equilibrium. We have heard a lot about the consequences of these price drops: job and income losses. I won't bother citing those figures again.

In the State of Texas, the impact has been very severe. We have already lost 150,000 jobs as a result of that slide that took place gradually over 5 years. We have estimated that if prices stabilize at $15, Texas could lose another 250,000 jobs. We could see up to half of the stripper wells shut in. And I think it is important to remember that across the nation, as well as Texas, 72 percent of the wells in production are stripper wells. Most of those wells were drilled during the 1970's, and drilling today has virtually ceased. It is at its lowest level in 10 years, and that is hitting thousands of small businesses.

These developments set the stage, I feel, for making a case for an import fee. We have heard about energy security. I think that is a very strong case that has been made by others. I am not going to dwell on the energy security issue. I would argue that the case for an oil import fee should be made in terms of adjustment assistance—adjustment assistance to an industry that is declining, that is restructuring.

And I believe if it is thought of in that vein, providing assistance through an oil import fee is consonant with approaches we have taken in the past to aid industries that were restructuring or declining in other regions. I feel an oil import fee would be the appropriate way to provide that assistance. It is not going to save or protect the industry. Exploration and drilling activity will continue to decline; but I do think an oil import fee, to the extent that it establishes a floor in, say, the $20 range, will impart some stability to the market and help us maintain at least a modicum of drilling activity that would preserve our energy security. In the current climate of uncertainty, there is no lending going on; there is no drilling going on. If we don't drill, we don't add to reserves. Remember that finding costs are a lot higher than production costs. It is easy to shut in a well, but it is time-consuming and expensive to open it back up. You shut in wells today; 3 or 4 years from now you want to open those wells; it is not easy. It costs almost as much to rework a shut-in well as it does to drill a new one.

On the up side, when times were good, the Congress saw fit to levy a windfall profit tax on the industry. The windfall profit tax since 1980 has collected $77 billion from oil producers. It seems to me that we should be providing some type of hedge on the down side as well through an import fee that would maintain the floor and bring about some balance in the way we intervene in the oil markets. Thank you.

Senator WALLOP. Thank you, Dr. Weinstein. Dr. Ebinger?

[The prepared written statement of Dr. Weinstein follows:]

THE NATIONAL AND REGIONAL BENEFITS FROM AN OIL IMPORT FEE

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Prepared for:
Subcommittee on Energy and
Agricultural Taxation, Committee
on Finance - U. S. SENATE

Date:
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Problems in the oil patch

For several years, the U.S. oil industry has been in the throes of a major structural adjustment. Manifestations of this adjustment include lower levels of production, a rash of merger and acquisition activity, and decreasing international competitiveness.

These structural adjustment problems have been exacerbated by the recent precipitous drop in crude oil prices. Since 1981, average prices have dropped about 60 percent, with more than half this decline occurring over the past two months. Consequently, the domestic oil industry finds itself today facing an extremely uncertain future.

Recent developments in Texas illustrate the severe economic dislocations that may occur if the free fall of oil prices goes unchecked. Since 1981, the state has suffered a net loss of 33,000 drilling jobs plus another 118,000 in oil-related manufacturing. The Center for Enterprising estimates that if oil prices should remain in the $15 range for the next several years, Texas could lose another 250,000 jobs while $30 billion of purchasing power is siphoned from the regional economy.

Of the many sectors within the oil industry, the exploration and drilling business has been hardest hit by the post-1981 price decline; and, barring remedial action, this sector will experience the greatest amount of distress from the 1986 price drop. Unlike the processing and distribution side of the oil business, exploration and drilling activity is dominated by thousands of small, independent companies. In Texas alone, there are over 5,000 drilling companies, oil-field service companies, and royalty owners. These "Mom and

Pop" producers are responsible for about 60 percent of the Texas' total oil production. They are, quite literally, on the front lines of the oil price war and will be the first to fall should prices remain at their current levels. Already, thousands of wells have been shut-in across Texas and other southwestern states. And most stripper well production, which accounts for 15 percent of the nation's output, will cease at prices below $17.

It is important to point out that while Texas and other energy-producing states may feel the initial pain of plummeting oil prices, other regions of the country will be affected as well. The oil industry employs close to 1 million workers nationwide. Though production is centered in the Southwest, administrative activities are concentrated in major metropolitan areas such as New York, Chicago, San Francisco and Los Angeles. (Ironically, none of the major oil companies producing in the state of Texas have their headquarters in the state.) As the industry continues to contract, jobs will disappear along the East and West Coasts as well as the Gulf Coast.

The case for an oil import fee

Because of the oil industry's strong backward and forward linkages to other industries, and because of still stronger linkages to several regional and local economies, its contraction has resulted in severe dislocations of workers and investment. Traditionally, problems associated with industrial and regional decline have bee met with *ad hoc* policy responses by federal, state and/or local governments. The auto, steel and agricultural industries have been the beneficiaries of considerable federal assistance, for example. At the same time,

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the experiences of other distressed industries and communities demonstrate clearly that such policies, however skillfully designed and implemented, cannot reverse industrial decline and local economic contraction. What is required, therefore, is a policy response designed to alleviate the more severe consequences of the process of industrial change without obstructing that process or imposing unacceptable and unjustified costs on taxpayers and consumers.

An import fee appears to be the most appropriate vehicle for dealing with the current set of dislocations resulting from rapidly falling oil prices. Within the context of the broad and long tradition of governmental assistance to distressed industries, an oil import fee would represent a comparatively passive measure that does not require the additional expenditure of federal monies at a time when the federal budget deficit has achieved a record high.

For the oil industry, an import fee would have a beneficial impact overall, though its consequences differ for the production and processing phases of the industry. For oil and gas extraction, an import fee would serve not only to slow the long-term decline in crude oil prices but also to mitigate the volatile fluctuations that have characterized oil prices since the end of 1985. Volatile fluctuations in oil prices, sometimes on the order of $2 per day, frustrate lenders and drillers who must pledge their future production as collateral in order to secure working capital.

Another result from an import fee would be the stabilization of the currently plunging rig count, which is currently 40 percent below year-ago levels. Over time, an import fee might serve to stimulate drilling modestly, despite the downward trend in oil prices. A stable rig count, in turn, would allow the industry to soak up the currently excessive inventories of drilling equipment, stabilizing the depressed machinery industry.

Certainly, over the long-term, an import fee would not halt or reverse the structural forces that are changing the production phase of the oil industry, but it would *slow* the process of decline sufficiently to allow drillers and manufacturers greater time in which to carve out new niches in the market or diversify.

For the processing phase of the industry, an import fee probably means a modestly higher price for crude inputs, although given the current state of the industry and its long-term prognosis, such a concern is largely a moot issue. Particularly as refiners move increasingly to relatively specialized, high value-added and demand-inelastic products, and out of basic petrochemical feedstocks, fuel oil and finished gasoline, crude oil costs will be of diminishing economic consequence.

The regional impacts of an import fee would be more pronounced. Effectively, such a fee would serve to mitigate the severe dislocations of workers and investment that currently characterize many parts of the once prosperous Southwest. Indeed, an oil import fee represents an equitable and cost-effective means of assisting declining regions and communities at a time when federal intergovernmental assistance is waning and other forms of federal largesse are threatened by Gramm-Rudman and other budgetary reductions. For energy-consuming states in the Northeast and Midwest, an import fee would likely have little negative impact because: (1) some of the fee would be shifted backward to producers of crude oil and refined products; that is, consumers would not bear all of the burden of an import fee, and (2) empirical evidence indicates that energy costs are an increasingly unimportant influence on manufacturers' production and location decisions.

For the national economy as a whole, an oil import fee would also yield benefits. The fee would raise additional federal tax revenue at a time when it is sorely needed. Most initial estimates place the value of such revenue at $40 billion over the next five years, given a $5 per barrel fee. In conjunction with a 15- to 20-cent increase in the gasoline excise tax, tax revenues could rise up to $100 billion. Moreover, the import fee would encourage the stabilization or slower contraction of an industry that has strong linkages to non-energy industries throughout the economy.

Tax and Regulatory Relief

Several tax reform proposals contain provisions calling for the removal of the oil and gas industry's current tax and regulatory relief advantages. Repeal of these preferences, which would effectively increase the tax and regulatory burden on an industry that is clearly distressed, is neither efficient nor equitable public policy. This is an argument applicable more broadly to all distressed industries and to all levels of government. Generally, increasing the tax and/or regulatory burden on a mature or declining industry will serve only to hasten its contraction.

Conclusion

The domestic oil industry has been in the midst of a contraction for the past five years, with the exploration and drilling side of the business suffering the most. With international oil prices continuing to fall, the long-term outlook for this sector is not promising.

Imposition of an oil import fee will not "protect" the domestic drilling industry. The contraction already underway will continue for the foreseeable future. But an import fee, based on a sliding scale that maintains a price in the $20 range, can help cushion the severe blow currently being felt by thousands of small drilling companies and oil-field service companies as a result of the 50 percent drop in average crude oil prices since last fall.

Finally, the question of energy security must also be posited as a justification for an oil import fee. In response to higher prices in the 1970's, increased domestic production and conservation enabled us to reduce our reliance on foreign sources of supply. From a dependency ratio that exceeded 50 percent a decade ago, we now rely on foreign oil for only about 30 percent of our national needs. If oil prices continue their freefall, we could once again become overly reliant on oil imports as domestic fields are shut-in and domestic production companies go out of business.

Today's low oil prices are not determined by free market forces. Prices have been depressed through foreign government interventions, most notably actions by Saudi Arabia and other OPEC producers. Similarly, rising prices during the 1970s were also the result of foreign governmental interventions. During that era, we imposed a windfall profits tax that reduced returns to domestic producers on the upside. An oil import fee in today's environment should be viewed as an appropriate balancing measure to ensure against undue risk on the downside.

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STATEMENT OF CHARLES K. EBINGER, PH.D., DIRECTOR, ENERGY AND STRATEGIC RESOURCES, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Dr. **Ebinger**. Thank you, Mr. Chairman. I, too, would like to summarize my remarks, but I ask that my complete testimony be put into the record. I would like to pick up where Dr. Weinstein left off and agree with him wholeheartedly that there is no such thing as a free oil market prevailing in the international arena today. I think it is very important for us to understand that the reason oil prices are falling today is because of a political decision by Saudi Arabia, supported by Kuwait and the United Arab Emirates, to force down the price of oil for the following reasons: to stop high cost oil production for a sustained period of time in areas such as the North Sea, the North Slope of Alaska, and other high cost areas around the globe; to slow inter fuel substitution, and possibly over time, even to back out other fuels development, such as coal, and natural gas to ensure that fiscal incentives for conservation do not have the degree of interest that they have had in the past when we had high oil prices, and finally, to stimulate world demand over time thus ensuring a return to OPEC's dominance of the world oil market. I argue in my testimony, Mr. Chairman, that even before the recent collapse of oil prices, there were a number of reasons that in my view ensure that in the 1990's OPEC will regain control of the world oil market.

I would like to amplify for the committee here today that at low oil prices sustained for any period of time, all the trends I highlight in my testimony will be exacerbated; the United States and our major allies will see our oil import dependence much larger and at dangerous levels by the mid-1990's. Mr. Chairman, I think it is important to understand that if oil prices remain at the levels they are today, or even drop as I believe they will under the onslaught of Saudi exports down to $10 barrel, that we will see a situation where the U.S. domestic industry may well be in peril.

I think it is also important to emphasize that low oil prices threaten the billions of dollars in alternative energy investments that have been made over the last decade. And as you noted yourself, Mr. Chairman, I share the strong concern you have about the viability of the U.S. domestic refining industry. In that regard, I would like to note that last December before Mr. Daniels subcommittee of the House Armed Services Committee, I testified that I thought further refining closings would endanger the ability of the United States to mobilize our country for a variety of political and strategic contingencies. If that testimony had any merit in early December, I think it comes back in spades today because, under the onslaught of cheap foreign petroleum products, we could well see ourselves reach a situation in the absence of a crude/product differential on oil import fees, where additional refinery closings will occur. It is for this reason that I think the committee must give serious attention to establishing a differential fee if an import fee is levied on crude oil and petroleum products; and I think the testimony of the independent refiners and the American refiners association give the essential guidelines on what issues are involved.

Finally, Mr. Chairman, I think we have to understand what is involved in this debate on the pros and cons of an oil import fee. This is not simply a question of taxation; it is not simply a question of regional equity although all these issues are important and certainly merit the committee's attention. Rather it is the question, as both you and Senator Hart have said, and Senator Boren stated yesterday: It is a question of how short are our memories. Are we willing to go back to levels of crude oil import dependence by forcing closings of domestic production that will ensure that by 1995 we are more dependent on foreign oil than we were in either of the last two oil shocks. I would like to remind the committee in that regard that in 1975 and 1979, both Secretary Simon and Secretary Blumenthal conducting investigations under section 232 of the Trade Expansion Act found the levels of our import dependence prevailing those times to endanger U.S. national security. Mr. Chairman, on the basis of current trends, if we do not act at some point in time to protect our domestic oil and gas industry, we will be back at import levels, in my belief, in excess of the levels found in those earlier rulings to endanger the long-term health and security of our Nation and that of our allies. Thank you, Mr. Chairman.

Senator WALLOP. Thank you, Dr. Ebinger.

[The prepared written statement of Dr. Ebinger follows:]

CSIS
Center for Strategic & International Studies
Georgetown University • Washington DC

Statement
of
Charles K. Ebinger
Director of the Energy and Strategic Resources Program
Georgetown University Center for Strategic
and International Studies

Concerning S1997 and S1507

Before the Energy Subcommittee
of the Senate Finance Committee
United States Senate

February 28, 1986

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Good Morning, Mr. Chairman,

I am Dr. Charles Ebinger, Director of the Energy and Strategic Resources Program at the Georgetown University Center for Strategic and International Studies (CSIS), a public policy non-profit think tank concerned with issues vital to U.S. foreign policy and national security.

Before commencing my testimony, I would like to thank you for allowing me the opportunity to present my views on the imposition of an oil import fee on crude oil and refined petroleum products as addressed in both S1997 proposed by Senators Wallop and Bentsen and S1507 introduced by Senators Boren and Bentsen. I would like to state that the views expressed are my own; CSIS does not,as a corporate entity, adopt institutional positions.

Before the Congress decides to levy an import fee on crude oil and petroleum products it is essential that the following questions be addressed: (1) What is the purpose of the fee, (2) Will the fee solve the "problems" leading to its enactment or will it create new problems, and (3) How should the revenue from the fee be utilized?

Mr. Chairman, few economists would dispute the fact that over time lower oil prices will provide a financial boon for the U.S. and international economy. Over time low oil prices will, if left untampered, lower domestic and global inflation, leading to a reduction in our balance of payments deficit. Moreover, if one believes the economic projections emanating from leading consulting firms (DRI, Chase Econometrics and Wharton), lower oil

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prices will lead to a surge in U.S. economic growth, U.S. government tax receipts, and falling budget deficits.

Mr. Chairman, while lower oil prices can provide a financial bonanza for the U.S. economy, they can also endanger our national security. It startles me how few people in Washington, especially in the policy making community seem to remember that when we held domestic oil prices down in the 1970s through a variety of regulatory policies, U.S. oil imports soared from 6.2 mmbd in 1973 to 8.8 mmbd in 1977. This occurred despite a concerted energy policy to reduce our dependency on OAPEC oil after the embargo of 1973-74.

The reason oil prices are falling today has little to do with a fundamental change in the oil market. Rather, it centers on a political decision by Saudi Arabia, Kuwait and the United Arab Emirates to regain control of the world oil market by forcing oil prices down to a level between $10-$15/bbl where inter-fuel substitution (coal, gas, nuclear, etc.) will be slowed or reversed, where fiscal incentives for conservation will be reduced owing to longer payback periods, where new energy R&D will be cut back, where new high cost oil exploration in Alaska, the Outer Continental Shelf, the North Sea and other high cost areas will be curtailed and where oil demand over time will increase, thus alleviating pressure on OPEC while increasing our dependence on the volatile Middle Eastern region.

Mr. Chairman, even before the recent collapse in oil prices there was little reason to be sanguine about the direction of global oil supply/demand. While it is true that nearly 7 mmbd of non-OPEC crude oil supplies have been added to the world oil market since 1979, by 1987-88, North Sea production will begin to decline, followed by the North Slope in Alaska in 1990. While some new production in the Third World will come on stream, if low oil prices prevail for any period of time, it is impossible to see this amounting to much more than 1 mmbd over the next decade. The fact that these events are occurring against the backdrop of the following events gives little reason for complacency:

1. A World Bank projected growth in OPEC and Third World oil demand of 5-7 mmb/d by 1995.

2. Declining East-bloc oil production and exports.

3. Major declines in the oil reserves of the United States (25 percent), the USSR (25 percent) and Western Europe (5 percent, despite the North Sea) over the last decade, which may accelerate at oil prices of $15/bbl.

4. Sagging U.S. oil production in the lower 48 States.

5. The prospect of major reductions in the growth of coal and nuclear power in many of the OECD nations after 1992 in the absence of major new orders and solutions to the acid rain and nuclear environmental issues, and

6. The transfer abroad by the OECD nations of many of their smokestack industries (steel, basic chemicals, cement, glass, etc), which may presage faster-than-anticipated rises in energy and oil consumption in parts of the Third World, especially at oil prices of $10-15/bbl.

Moreover, few policy-makers in Washington seem to be paying

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attention to the effect that falling oil prices in the short-run may have on medium-term energy supplies. Between 1963-73 world oil production grew by 25.5 mb/d at a cost of $76.2 billion ($3,000/b of productive capacity). In contrast, between 1973-83 world oil production grew by six million b/d at a cost of $240 billion ($70,000/b of production capacity). While inflation accounts for some of this differential, what these figures clearly tell us is that it is becoming more expensive to find oil, the risks are rising exponentially, and we are finding less of it. At low oil prices the above trends will not only be exacerbated but we could also see a sizeable increase in demand for imported oil as mothballed oil fired electric generation facilities (up to 1.5 mmbd) are brought back into production and high stripper wells (1 mmbd) are closed down.

Given the uncertainties of the market, the following conclusions can be drawn. First, as long as fears of a price collapse or sustained low prices (2-3 years) persist, commercial inventories will remain lean and investment in new exploration and production both inside and outside OPEC will fall, leading to an erosion of global reserve/production ratios. Consequently, it appears likely that by the early to mid-1990s, demand for OPEC oil could hover in the 23-25 mmbd range or even higher if low oil prices persist four or five years. In such a scenario, a political upheaval in any major oil producing country could send oil prices skyrocketing. This prognosis would be disturbing enough, simply on the basis of supply and demand analysis, but unfortunately, OPEC's oil pricing and production decisions do not occur in a vacuum but, as we have seen in 1967, 1970, 1973-74 and

1980, are deeply influenced by political events exogenous to the oil market. Likewise, even in major non-OPEC oil producing nations political upheavals could send shudders through the world oil market.

It is this fact more than any other that leaves the U.S. dangerously exposed to another oil price shock during the mid-to-late 1990s. The spectre of another Arab-Israeli war, the spread of the Iran/Iraq war, the coming to power of anti-Western Islamic fundamentalist regimes, or even terrorist attacks against major oil installations, are all factors that could tear asunder the pragmatic assumptions of Western supply and demand forecasts.

Likewise, those who automatically and complacently assume that OPEC, and especially the Gulf producers, will tailor their production levels to meet world oil demand in the 1990s, do so at their peril. The question we should be asking is, what if Saudi Arabia decides to avoid the financial surpluses of the past and produces only five to six million b/d over the next decade? What if a new generation of leaders, concerned about the erosion of their societies' values brought on by modernization and westernization, decide that their 'black gold' should remain in the ground.

Mr. Chairman, it is against the backdrop of these concerns that I believe debate over the merits of an oil import fee should commence. Because I believe we are setting ourselves up for another oil shock, I would support an oil import fee when oil prices reach a level that threatens our domestic oil production. Over the last thirteen years, we have achieved enhanced energy

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independence through conservation, and the development of high cost domestic energy resources, most of which will be placed directly at risk at sustained oil prices below $15/bbl. Free market economics are fine and in general should be encouraged but not when they threaten our long term national security.

It is for this reason that I am opposed to utilizing an oil import fee exclusively either to reduce the federal budget deficit or to lower marginal tax rates. This is a pusillanimous way to avoid tough policy choices in the national defense and broader economic policy arena. To the extent that we impose an oil import fee or a gasoline tax, the revenue derived should go primarily to protecting the long term energy security of the nation by increasing purchases for the Strategic Petroleum Reserve (SPR), to assure that domestic oil and natural gas production does not fall off precipitously, to encourage the development of new energy sources by supporting both federally funded research and development and by enacting taxation policies that support energy development. An oil import fee only has justification on a national security basis if it helps insure the long term energy security of the nation.

Mr. Chairman, while other witnesses may make politically compelling or cogent cases for exemptions from an oil import fee, I must concur with the testimony of Mr. Jandacek presented yesterday and urge that you reject all cries for exemption from an oil import fee were one to be levied. The history of U.S. energy policy during the entire post war period is full of lessons of what happens when special interest groups, be they particular regions or industries, are allowed to dominate energy policy. In almost every case, the problems that the proponents of special treatment have used to justify their arguments have created far more problems than they have solved. Witness the impact of the Mandatory Oil Import Program from 1959-1973, the full exemption of residual fuel oil from that program after 1966, and the fuel allocation system set up by the Emergency Petroleum Allocation Act, which created unnecessary gasoline lines during the oil crisis of 1979-1980.

Mr. Chairman, the only exception that should be made if an oil import fee is levied is to insure that the domestic refining industry not be further assailed by unfair competition from foreign refiners who are not subject to the same environmental and other regulatory laws under which U.S. domestic refiners must operate. I want to make it clear that I am not asking for special treatment but only for equal treatment so that fair commercial competition may occur.

Mr. Chairman, last December I testified before the House Armed Services Committee at the request of the Independent Refiners Coalition, a consortium of 31 refiners, on how rising volumes of oil product imports subsidizd through a variety of mechanisms were potentially endangering U.S. national security. I warned that further refinery closings under the onslaught of "cheap" foreign products could pose serious questions about the United States' ability to meet our fuel requirements to support various national security contingencies.

Neither I nor the IRC asked for special protection for the U.S. refining industry. Rather we urged an investigation by the

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Administration under section 232 of the Trade Expansion Act of 1962 of the national security implications of rising volumes of oil product imports. To date our request which has been supported by 44 Senators remains unaddressed.

Given the ongoing seriousness of this problem, I must concur with the Independent Refiners Coalition and the American Independent Refiners Association that if an import fee is levied, the Congress must insure that a higher price differential be established between the import fee on crude oil and on petroleum products, to insure that our domestic refining industry not be placed in further jeopardy by lower cost foreign imports not subject to the same regulations and enhanced costs. Our failure to establish such a crude oil/petroleum products fee differential will not only lead to serious market distortions but will also close down additional refining capacity, posing grave threats for U.S. national security.

Mr. Chairman, for the past thirteen years, U.S. government policy has been to reduce our dependence on insecure sources of oil through a variety of market and non-market mechanisms. Our failure to continue those efforts and perhaps ever to allow some of our successes to be reversed during this period of declining oil prices will endanger the long-term security of the nation.

Thank you, I would be delighted to take questions from the Subcommittee.

Senator **Wallop**. Let me toss a question to the panel, and each or any of you may comment on it. How much validity is there to the thesis that oil is the sort of gold standard of the BTU business, that the economic viability of other forms of energy plays off of a price royal, whether it is coal, natural gas, cogeneration, or a variety of conservation measures that we have picked up in the recent decades? Is that a valid concept, or is that just partially valid, or is it totally invalid?

Dr. **Yergin**. Let me take a crack at that. I think we could sort of think of oil as compared to the dollar in the international currency markets. The oil is the key energy currency, and most everything to one degree or another plays off of it, specifically natural gas. And over the next couple of months, we are going to see the natural gas producers in the United States reeling from the pressure of falling oil prices—and to a lesser degree coal. It is more complicated when you get into utilities because of the nature of the investment people have made; but oil is the pacesetter.

Senator **Wallop**. But they have a fairly large investment in the American utility industry, the utility business, in fuel-switching capability, don't they?

Dr. **Yergin**. Right.

Senator **Wallop**. Developed over the last decade.

Dr. **Yergin**. Yes; we are just trying to put some numbers together on the fuel switching, and we see that there would be some but that the gas producers would come back and be very competitive again because they have no choice. And those who are using coal would be slower to respond.

Dr. **Weinstein**. I would tend to agree with that. I think the greatest substitution occurs between oil and gas, and over time I think those fuels tend to reach some type of BTU equivalency in pricing.

Dr. **Ebinger**. Could I add one point to that, Mr. Chairman?

Senator **Wallop**. Yes.

Dr. **Ebinger**. I have recently been looking at this problem and was somewhat startled to see that we have about 1.5 million barrels a day of idled oil-fired electric generating capacity in the country which, of course, has been backed out by alternative fuels such as coal and nuclear power. In this regard, I call to the committee's attention a recent study by a local consulting firm, Science Concepts, which specializes in the electric utility area. Their assessment is that at a price somewhere around $10 or $12, a significant portion of this capacity could be brought back into production, backing out coal and gas. Of course, any additional demand for oil arising from that added demand in the electric power sector would have to be met by imports.

Dr. **Yergin**. If you go back, Dr. Ebinger spoke about the strategies that are at work in the oil market. If you go back as much as 5 years ago, you, will find that some of the OPEC countries were particularly talking about the loss of electric utility markets. And, certainly, on their agenda, from the viewpoint of the exporters, they would like to, around the world, not just in the United States, regain those utility markets to the degree that they can.

Senator Wallop. Dr. Yergin, do you see us, absent some kind of action, sliding back into the kinds of vulnerability we had in 1973 and 1979?

Dr. Yergin. I have been doing a sort of broad strategic overview of the development of the oil industry, and I think it is a cyclical industry and that energy security is a concern that long predated OPEC and is a recurrent problem. We could be in that position again at some point in the future. And, certainly, at lower prices rather than higher prices, there will be less activity in the United States.

Senator Wallop. But you mentioned that even considering oil import fee legislation from any dimension was giving validity to an OPEC argument, that we were interested in reaping their profits to ourselves. And yet, I quoted yesterday and I would like to again—there was an article, a little tiny one, in the Wall Street Journal on November 11, by a man named Mohammed Akasem, who is the economist at the Saudi Fund for Development. This was November 11, 1985, and in that article, he outlined a strategy for the recovery of OPEC, and it has taken place. He said that as early as the end of this decade, "the poorer oil producing countries will have depleted their resources to the point that the six Persian Gulf producing countries will possess a significant portion of the world's oil reserves." He states that: "These Gulf producing states will then be in a position to better control the market through strategic flooding, if necessary. In addition, the new ERA, which will result among the remaining OPEC powers because of common religion and natural resource based economies, would make it easier for them to agree on policy and share information. It would allow a relatively slow depletion rate and a stable growth of oil prices over time."

Now, some of this has taken place. We have seen certain African states being backed out just by the price that has taken place, even before the slide that began in November. A lot of people were going home from oil producing countries, to Egypt, to Jordan, to Morocco—scientists and engineers and people who were trained. Is this what Akasem was talking about, only in 1986 instead of by the end of the decade?

Dr. Weinstein. I would agree with that assessment. It seems to me that the Saudis particularly are playing a game somewhat similar to the Standard Oil Co. in 1911 when it was flooding the market to drive out competitors. The United States is a high-cost producer, and OPEC knows that. It is one of the unfortunate effects of our geology. We used to be the second largest producer of oil in the world. Now, we are the third largest producer of oil in the world, and we could soon be the fourth if we keep shutting in our wells and we stop drilling new ones.

So, I would agree with his assessment. This, clearly, is a long-term strategy that OPEC is pursuing, and Saudi Arabia in particular; and it can once again make us extremely vulnerable. Ten years ago we depended on imports for about 50 percent of our oil needs. We are down to about 30 percent today; but I could see us shooting up in the next couple of years over 50 percent.

Dr. Yergin. Dr. Weinstein mentioned Standard Oil; and the term they used to use when they would flood the market and to put pressure on other competitors was that they were giving the market a good sweating. And that is very much what we are seeing today and is reflected. And in this oil war, there are really three fronts on which it is being fought. One is OPEC versus non-OPEC, which he has just described. The second is oil versus other energy sources, as you were talking about. And the third, which is to some degree reflected in that quote, is within OPEC; that it is one group of OPEC countries trying to turn the tables on the other.

Dr. **Ebinger**. Mr. Chairman, if I may add some additional points, I think it is important to understand that from the viewpoint of Saudi Arabia, they had very little choice. As you well know, they were down to production levels last year of 2 million barrels a day since they were the one country trying to maintain prices. I think it is important for this committee to understand that the decline in the U.S. dollar was also behind Saudi policy because most of Saudi's foreign assets are held in European or Japanese banks; consequently,as the dollar declined in value, the relative buying power of those assets fell substantially in shart contrast to the situation that had prevailed with a high dollar. We should not fail to realize that U.S. trade policy left the Saudi's—an important U.S. alley, in a very difficult situation.

Finally, it should be noted that, the slowing down in the United States and world economy also led the Saudis to believe that the oil demand wasn't going to come back, given their current policies. This is why I believe they are prepared to regain control of the market; and if that means flooding the market by even higher volumes of production than they are currently producing, I believe they will do so. It is this concern that I believe places so much vital emphasis on the need for protection of our domestic oil and gas industry.

Senator **Wallop**. OK, but then does the oil import fee work for or against the Saudi's plan of achieving the back out of higher prices?

Dr. **Ebinger**. The irony is that it probably works against the Saudi policy; especially if we were to enact a flat fee. If we had a sliding scale fee, then it would probably not do so. For example, Say the price of oil is $15/bbl, and we put on a flat $5/bbl import fee; if there is no sliding scale provision then, of course, the Saudis have the option to drop the price to $10, thus offsetting the impact of the fee.

I am also worried, and I don't know if Dr. Yergin or Dr. Weinstein would share this concern, that I can see a situation where, if we did put on an import fee, that it would be a high stakes game. In this situation, the Saudis could well lower the international price of oil, namely what everyone else is paying, to very low levels by raising production—I mean to levels below $10. In this situation, we could have a very serious dichotomy between our own domestic price and the world price; but I think that is a cost we may have to pay.

Senator **Wallop**. That, of course, is the argument of the State Department: That the fee would actually tend to lower world prices rather than to stabilize them.

Dr. **Ebinger**. It could, depending on how it was imposed.

Senator WALLOP. Then, are you suggesting that it would be better to be on a sliding scale?

Dr. EBINGER. I think it would definitely be better to be a sliding fee.

Senator WALLOP. Pegged to, as we call it, a survival price.

Dr. EBINGER. Pegged to a price where domestic producers would continue to have an incentive to produce.

Senator WALLOP. Do you agree with that, Dr. Yergin?

Dr. YERGIN. I think that there is great merit in looking at it that way, especially if your focus is, as you have laid it out, to seek out what your focus is. Is it revenues or is to lead to a viable domestic industry? And a variable tariff is what really applies to the second situation. And I think that you posed the question last December and I think again today, that one of the most important aspects is to try to figure out if you do want to go the route of a variable tariff or a variable fee, what that appropriate trigger level is.

At this point, I would say that this is one of the three questions that are coming out of this hearing that are well worth considerable more focus in sharpening that issue for we are now looking at prices that, 4 or 5 months ago, most everybody simply thought were unthinkable; they thought could not happen. And I think that much of the industry, both in the United States and worldwide, is still in a sense in a state of shock, stunned by what has happened, and that it is a time for some clear thinking on it.

Senator WALLOP. But this decline in prices, generally speaking, is relative to the stable U.S. dollar relative to other currencies. It is down from its inflated value.

Dr. WEINSTEIN. That is a tough question, how the price of oil is affecting the value of the currency.

Senator WALLOP. I say that not because I am an expert on currency values but because I read it. So, that is an inquiry rather than a statement.

Dr. WEINSTEIN. I think maybe it works the other way. As was discussed earlier, international oil trade is priced in dollars; and the dollar is worth less than it was a year ago. The value of the receipts being received by the oil exporting nations, in terms of what they can use those funds to purchase, is not what it was some 18 months ago. How that all fits into the equation of falling oil prices is hard to decipher. I would concur with the view of my colleagues here that the way to go on the oil import fee is the sliding scale.

Senator WALLOP. How do we determine where that fee should be set? I am not entirely comfortable if $22 is right, although Dr. Singer suggested yesterday that we have come pretty close. But in light of other economic effects that have been identified with a sense of sincerity by witnesses in opposition to this, how do we examine whether we should make a survival price, if you will, that leaves some domestic exploration and production capacity and some relative capacity for the other related fuels and still sort of fits into an economy without doing serious damage in another dimension?

Dr. EBINGER. Let me take a stab at that, Mr. Chairman, because it is a difficult question, as you have said, and I certainly agree with you, the future economics of oil and gas drilling aren't just related to the fee but will be affected by what we do with the Federal windfall profits tax and other tax provisions which, of course, are still under active debate by the administration and by the Congress.

Consequently, I think it is very difficult to choose a particular level for the fee. I would simply say that we want to ensure at a minimum that measures such as the windfall profits tax in these difficult times and some of the provisions that would curtail favorable tax treatment of the oil and gas industry do not further imperil our domestic oil and gas industry. Certainly this is not the time to tamper with an existing taxation system that has encouraged oil and gas drilling; however it may well be the time to get rid of the Federal windfall profit tax and then see where we are in terms of what we need to do additionally to ensure oil and gas drilling.

Senator Wallop. There is a proposal that is floated in the Wall Street Journal this morning that goes in high speed in the opposite direction, and that is to remove the deductibility for excise taxes, which would exacerbate the effect of the windfall profit tax, not minimize it.

Dr. Weinstein. I don't think it would be difficult to ascertain an appropriate benchmark price. I think there is plenty of engineering and production information out there that could be used to determine what price would ensure an adequate rate of return to drillers and a level of drilling activity sufficient to maintain our national energy security. And I would guess that is somewhere in the $20 to $22 price range.

Dr. Yergin. Well, I would just say that I think it is a researchable proposition. It might turn out to be somewhat lower than the $20 to $22. It might be in the $18 range. Of course, not only are there the tax elements that have been pointed out, which have a very important impact, but it is also the cost to the industry in terms of the fall in terms of oil service costs and so forth that have to all be factored in; but it can, I think, be researched.

Senator Wallop. I want to thank you all for adding to the dialog on these issues. It is a matter of fascination to me. I suspect that about the best we will have done, when all of this is over, if I read the reaction of some members correctly, is at least create the climate where the tax treatment of the industry will not be quite so drastic as it has been proposed in S. 3838.

Dr. Yergin. And what you do see around the world is, as prices are falling, governments who want to attract new oil and gas development are continuing, such as in the North Sea, looking at their tax codes and seeing how to take the pressure off.

Senator Wallop. Let me ask you one thing. Is it a likely event or a possible event that Japan would protect its own investment in alternative fuels and other things by such a fee?

Dr. Yergin. There are strong—as I say, it is not well recognized, but there are strong indications that there are important elements within the Japanese industry and within the Japanese Government who would be trying to look at longer term and see they made this huge investment in diversification in the 1970's. It is one of the factors that has helped create the surplus in the oil market. They tend to try and take a longer term perspective, sometimes more

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than we do. But they also will look very carefully to see what we do.

Senator **Wallop**. It would be ironic in light of the State Department's testimony if we ended up without and they ended up with, and the International Energy Agency and others were paid the kind of lip service that I sometimes think that most of the rest of the cosignatories of that agreement pay it, as opposed to ourselves. Again, thank you all very much.

Now, we have a panel consisting of Dr. Emma Brossard, director of policy analysis of the Center for Energy Studies at Louisiana State University; Mack Wallace, commissioner of the Railroad Commission of Texas; Ronald S. Wishart, vice chairman for public affairs, Union Carbide Corp.; and Thomas J. Donohue, president and chief executive officer of American Trucking Associations.

Dr. Brossard?

STATEMENT OF EMMA BROSSARD, PH.D., DIRECTOR OF POLICY ANALYSIS, CENTER FOR ENERGY STUDIES, LOUISIANA STATE UNIVERSITY, AND MEMBER, LOUISIANA GOVERNOR'S TASK FORCE ON NATURAL GAS, BATON ROUGE, LA

Dr. **Brossard**. Thank you very much for inviting me to testify here today. It is a great honor. I am Emma Brossard, director of policy analysis at the Center for Energy Studies, Louisiana State University. I am also a member of the Louisiana Governor's Task Force on Natural Gas; and I am also a consultant for the Venezuelan oil industry. I here represent only myself, however, in my testimony.

As Senator Pell reminded us, we must remember history; and in my opening remarks, I would like to point out a couple of very important historical facts because they have been alluded to today, but they have not really been addressed.

First of all, the normal oil market is historically one which is of oversupply. Therefore, it is very competitive. Not only is there a normalcy in oversupply of crude products, but also of refining capacity. An oil glut developed in the United States in the late 1920's which grew to saturation after the 1930 discovery of the East Texas oilfield. The subsequent drop in the price of oil from $1.27 a barrel in 1929 to $0.65 in 1931, plus the Great Depression, caused Congress to pass the Revenue Act of 1932. The 1932 act, which levied a duty of $1.05 a barrel on foreign gasoline and $1.68 on lubricating oil and $0.21 a barrel on crude oil, as well as fuel oil and other derivatives, had immediate and long-term effects.

Among the immediate effects, Standard Oil of New Jersey, now EXXON, grew even larger. Gasoline imports stopped, and oil imports were cut in half, that is crude. And the price of U.S. oil rose!

The long-term effects were not foreseen. The oil tariff rearranged the world's markets and hurt the U.S. oilman who, before the tariff, had been the largest exporter to Europe. His exports were replaced by Venezuela's oil, and the American oilman lost the foreign markets. It was an American boomerang.

The next great oil glut occurred in the 1950's, after the U.S. oil companies had gone abroad and had become very successful. The U.S. Government resolved that problem with the Mandatory Oil

Import Program in 1959; and the result was the formation of OPEC in 1960. While Europe and Japan benefited from the cheap OPEC oil, the U.S. paid higher prices—an American boomerang.

Congress is once more considering an oil import fee that would give the United States another boomerang. The oil import fee is now being considered in order to raise new revenues for the Federal Government and it is being sold in the oil patch as a means of helping to raise the price of domestic oil for our producers.

However, not all oil producers are taken in by this. The independents of Louisiana have just voted again in LAIPRO, and they have voted to oppose the oil import fee. They wanted crude oil deregulation, and they got it. And they are now willing to take the risk, along with the rewards. They do not want the Federal Government back in controlling them again.

I would suggest to you that, instead of Senate bills 1997 and 1507, a more rational approach would be to abolish the windfall profit tax which discourages oil production, and avoid the imposition of new discriminatory treatment of the oil industry, particularly the so-called alternative windfall profit tax which is now being suggested to you by the Reagan administration.

A positive approach would be the adoption of Louisiana's Senate President, Sammy Nunez' LEAP proposal. Senator Nunez has proposed providing tax breaks to oil companies drilling exploratory wells as a stimulus to the industry as well as to the State economy. He would suspend collections of oil and gas severence taxes and the State's natural gas royalty income for a 3-year period. The Governor's Task Force, which I am a member of, has voted unanimously to support Senator Nunez' LEAP proposal, a positive step in helping the State's depressed economy.

I would like to submit to you a copy of the LEAP proposal to be included in the record along with my testimony. Other States are now studying it, and I would urge you to also consider it. I thank you for the privilege of appearing.

Senator WALLOP. Thank you, Dr. Brossard. I think in many respects we may have laid the groundwork for that very kind of action by holding these hearings; but for your interest and that of witnesses who have just testified who may still be in the room, Reuter's News Service Report, just in, said Sheikh Yamani of Saudi Arabia just held a press conference and announced that the price would continue to fall to $10. Now, there are some interesting things happening out there, and when one country can say the price is going to continue to fall, this gives rise to the thesis that we do not have a free market. Whatever else it is, it is manipulated; and I think, Dr. Brossard, you have pointed that out as well.

Mr. Wallace?

[The prepared written testimony of Dr. Brossard and a copy of the LEAP Program follow:]

STATEMENT MADE BY EMMA BROSSARD

AT THE PUBLIC HEARING
on
S. 1997 and S. 1507
PROPOSALS TO TAX IMPORTED OIL
of the
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
of the
COMMITTEE ON FINANCE
UNITED STATES SENATE

February 28, 1986

It is a great honor for me to testify before this Senate Subcommittee on Energy and I thank you for the privilege.

I am Emma Brossard, director of Policy Analysis at the Center for Energy Studies at Louisiana State University, and a member of the Louisiana Governor's Task Force on Natural Gas. In my testimony, I represent only myself.

These are very important hearings that you are holding and I am very grateful for the opportunity to include a somewhat different point of view. I oppose the oil import tariff from a national strategic perspective. I have been impressed with the strategic importance of oil since I was a child growing up in Venezuela during World War II. My father was a pioneer in the Venezuelan oil industry - a young geologist from Wisconsin who went to Venezuela in 1922 with Gulf Oil. It was his job during World War II to see that American oil tankers heading north loaded with Venezuelan oil made it safely through the Caribbean Sea, avoiding the Nazi U-boats. I, therefore, know first hand the value of good allies, and the importance of the petroleum industry.

We should also reject an oil import fee because it is -

> "the worst and most damaging of all energy tax proposals. Why? Because price hikes in imported oil quickly spread to domestic oil and other fuels. Thus, a fee creates a very large consumer price rise and drag on the economy but yields a relatively small net gain in new Treasury revenues. Domestic energy producers get most of the rest."
>
> Philip R. Sharp, Chairman
> U.S. House of Representatives
> SubCommittee on Fossil and Synthetic Fuels
> Committee on Energy and Commerce
> January 30, 1986.

The proposed bills, S. 1997 and S. 1507, to tax imported oil will harm our national security. First, the U.S. is not self sufficient in oil and must import one-third of what it consumes. Oil imports will rise by 1987 when Alaskan North Slope production peaks.[1] Second, in periods of mobilization or wartime, secure foreign supplies are essential to our survival. Therefore, a new oil import fee would not only increase the cost of our oil imports but harm our oil producing trading partners who might remember this the next time the U.S. faces a crisis.

A. U.S. Oil Reserves and Production

As U.S. reserves have decreased from 39 billion barrels in 1970, to 28 billion in 1985, U.S. citizens have become more complacent. This, of course, doesn't make sense. Decreased reserves should be of concern to us, particularly when we are so dependent on this nonrenewable resource. The U.S. has not added a major oil field to proven reserves since Prudhoe Bay was added in 1970. (Kuparuk River field, also on the Alaskan North Slope, with 1.4 billion barrels, has since been added to our reserves, but it is not nearly so large as Prudhoe's 9.6 billion, or East Texas' 6 billion barrels discovered in 1930.) It is obvious that we are not replacing our annual consumption rate, which is now around 5 billion barrels. Consequently, U.S. oil imports will increase.

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[1] Since 1947, the U.S. has imported more oil than it exported. Net imports (total imports minus total exports) rose from 2.4% in 1948 to 16% in 1958, to 20% in 1968, to 36% in 1973, to 41% in 1976. Source: U.S. Bureau of Mines Mineral Yearbook, 1947-1976.

Furthermore, in 1984, the Energy Information Administration (EIA) pointed out in its annual report on crude oil, natural gas, and NGL reserves that the biggest increases for 1983 came not from new discoveries, or extensions of older fields, but *from revisions* and adjustments to estimates of reserves in existing fields. As the *Oil and Gas Journal* editorial for October 1, 1984, pointed out, "What increased were bookkeeping barrels, the kind that can't be counted upon to reduce U.S. dependence upon imported crude. Net revisions and adjustments jumped 462% for oil ...."

And in 1985, the EIA's report on domestic reserves for 1984 increased U.S. crude reserves by 2.6% due to enhanced recovery techniques. The EIA said: "The 1984 increase resulted primarily from the largest *net revisions* to reserves (2.445 billion bbl) that occurred during the 1977 through 1984 period."

Texas, our largest producing oil and natural gas state, peaked its crude oil production in 1972, and since declined at an average annual rate of 3.5%. Its production averaged 2.3 million b/d in 1985 compared to 2.4 million b/d in 1984. The Texas oil production for 1985 came from 209,040 total wells; and 192,793 of these had artificial lift, i.e., only 16,247 wells were flowing. The U.S. has the greatest number of oil wells in the world: 620,000 wells (out of a total world 830,000 wells) and 94% of U.S. wells are on artificial lift.

The reason that the U.S. has three-quarters of the world's oil wells is because the U.S. has an estimated 440,000 stripper wells producing 10 b/d or less. And the reason they have so many stripper wells is because U.S. citizens own private mineral rights. Stripper wells are concentrated in the leading oil producing states. According to the American Petroleum Institute (API), strippers account for 56% of the oil wells in California, 60% in Texas, 71% in Louisiana, 81% in Oklahoma, and 96% in Kansas. The stripper fields in the U.S. are estimated to contain nearly 4.6 billion barrels of oil, most of which can only be produced through the use of costly secondary methods. The strippers produced nearly 22% of all U.S. oil production in 1984, according to the EIA. Their numbers increased as the price of oil rose. With lower priced oil, some of the stripper wells will become uneconomical to operate and they will be shut in sooner than otherwise.

Alaska, the U.S.'s second largest oil producing state, needs a major discovery to reduce declining production expected to begin after 1990. North Slope oil production will peak during 1987, slightly over its present production of 1.8 million b/d. Alaska has long lead times between exploration and production. Fortunately, it has the Trans Alaskan Pipeline System in place to carry North Slope oil to Valdez for shipment to the Lower 48. Billions of dollars are being spent by the major oil companies in their search for more oil reserves, as well as maintenance of present production on the North Slope.

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World Oil reported in November 1984 that over the past six years the 15 most active U.S. oil companies replaced only 44% of the oil they produced in the U.S. "More than $113 billion were spent in the U.S. by the 15 most active companies." (Of this $113 billion, $25 billion went to lease acquisition costs.) The article points out that if this poor record is not improved, "operators will shift emphasis from the U.S. to more prospective countries." Can present U.S. reserves be sustained at reasonable costs if these top 15 companies, who rank at the top in exploration spending and drilling, have only a 44% replacement record? (Arco, Amoco, Conoco and Shell, however, replaced nearly all their oil and gas production during the 6-year period.) The annual reinvestment of cash flow from internal sources is a one-for-one ratio in company-wide capital spending to cash flow.

Often forgotten is that foreign oil investments in the past contributed to the U.S. international balance of payments. For each dollar of foreign investment, more than $2 of repatriated earnings were produced for domestic oil development. U.S. oil companies were enormously successful abroad and probably contributed more new capital to the U.S. economy than any other industry. They distributed their foreign earnings to shareholders in the U.S. as dividends and taxes were paid to the U.S. Treasury.

In practice, the greater part of the price of a barrel of crude oil ends up as revenue for governments, particularly the Federal Government. The U.S. Government has the most expensive offshore lease sales in the world! Federal lease sales and taxes add enormously to the cost of producing oil, particularly in Alaska.

Exxon recently published a study on "Adding up Taxes on Oil and Gas," by Joseph M. Dukert, a Washington consultant. The following are some of Mr. Dukert's findings:

> Direct federal taxes on leading oil and gas companies from 1980 through 1984 far exceeded the dividends paid to their shareholders. They even surpassed total net income earned by those companies. In fact, these direct taxes were almost twice as high as the national average for other large companies.

The oil and gas industry contributes at least $35 billion each year to federal and state governments. These costs can be broken down in an average $1.20 gallon of gasoline as computed by the API.

$ .09 -	Federal excise tax
.125 -	State and local excise taxes
.05 to .15 -	Severance taxes
.03 to .15 -	Windfall Profit Tax
.08 to .09 -	Royalties
.0125 -	Property taxes
.01 -	Corporate income tax on refiners
.01 -	Corporate payroll taxes
$ .41 to .64	Total Government Revenue (excluding taxes paid by distributors and dealers, or lease bonuses)

B. Foreign Oil Supplies

Since World War I, oil is a strategic mineral. When the U.S. entered World War I, few U.S. Americans saw any connection between the nation's security and petroleum reserves outside the U.S. However, the U.S. Government made control over foreign oil reserves that were needed for the U.S. navy and the U.S. economy its primary foreign-policy objective. It is, therefore, important to maintain good relations with our oil producing neighbors and allies, as well as secure refueling depots around the globe for our armed forces. The proposed oil import bills would harm our allies who are oil producers. A new import tariff, imposed to raise revenues to compensate for the virtual elimination of the Windfall Profit Tax, as a result of the decline in the price of crude oil, would boomerang on U.S. citizens.

After the Armistice, Lord Curzon declared "The Allies floated to victory on a wave of oil." He might have said the American wave of oil. U.S. refineries supplied 80% of Britain's petroleum products from 1914 to 1916, and in 1917 the U.S. supplied 92%. After the Russian Revolution in 1917, the oil in Baku was cut off, creating a fuel oil emergency. Fueling the Allied war machines drained many U.S. oilfields.

Unfortunately, the British soon forgot about the U.S. "wave of oil" in winning the war. The British tried to prevent U.S. oil companies from acquiring foreign sources of supply, and British officials went so far as to claim that Great Britain controlled all fields outside the United States and 50% of the world's oil reserves. (Ludwell Denny, America Conquers Britain, New York, 1930; and We Fight for Oil, New York, 1928. Joseph Tulchin, The Aftermath of War, New York, 1971)

Then, there was World War II. Half of all the tonnage sent to Europe to the war zones were oil products. In some invasions, oil products made up 65% of the war supplies. This fact was brought out in a speech by the U.S. Secretary of the Interior, Oscar L. Chapman, at the National Petroleum Conference in Caracas, Venezuela, in September 1951:

> It is my opinion, --- the contribution of Venezuela in this war effort never received the credit it deserves. Your domestic oil production was increased by 50% during the war and this increase may have been the margin of difference that tipped the scales of victory in our favor.

> Also, this country and mine, produced nearly all the petroleum supplied to maintain the Allies military war machine. Naturally, since the United States has worked for a long time in the field of oil production, they made the major contribution of oil in the war effort. However, if you judge the contribution from another point of view, the aid from Venezuela was second to none.

Earlier in his talk, the Interior Secretary spoke of the first 12 months of the Korean War when the United Nations shipped 50 million barrels of oil products to supply our military forces. Once more, this was a combined effort by the U.S. and Venezuela to supply the needed oil.

Lest we forget, who our allies are in time of war and peace! Let us not repeat what we did to Venezuela under the Mandatory Oil Import Program in 1959, and what the British did to us after World War I. We, too, forgot the aid that made it possible to win a World War. If there is any lesson to be learned from this, it is that nations, i.e., governments, are quicker to forget help given than individuals. There is a certain irony here regarding the U.S.'s help for the Allies in World War I, i.e., the way we were repaid by the exclusion of aliens owning or operating oil properties within the British and Dutch Empires, and the way the U.S. in turn prevented Venezuela's principal export from entering the U.S. (during a very difficult internal period for Venezuela). It is particularly curious when you remember how hard the U.S. government worked for an "open door" for oil exploitation (Bernard Baruch) after World War I and the fight for oil concessions, particularly in the Western Hemisphere (Mexico, Colombia and Venezuela). By 1925, U.S. oil companies were in Venezuela and starting to develop its enormous oil reserves. They along with Shell made Venezuela the largest exporter of oil in the world from 1928 to 1970.

During World War I, the Federal Government tried to restore the broad integration of the oil industry, which it had largely broken up with the U.S. Supreme Court decision regarding Standard Oil, in 1911. The dissolution of monopoly and the emphasis on competition changed to a public policy that stressed cooperation. The Navy was concerned about adequate supplies of fuel for the country's fleet. Foreign sources of supply were needed to supplement domestic reserves.

This obsession for *sufficient* supply that drove U.S. Americans after World War I, and the British and Dutch before them, seems to have been forgotten in the present discussions of oil imports. The United States' dominant place in the worldwide struggle for petroleum was driven by a fear of the exhaustion of domestic reserves. However, after 1949, the fear of depleting U.S. oil reserves seems to have disappeared and has not been a strong factor in our public policy.

The United States has gone through three distinct periods of public policy since World War II. *First*, the period of the 1950s and 60s when U.S. policy was to protect the domestic producer. *Second*, the period of the 1970s when U.S. policy was to protect the U.S. consumer against higher priced oil and natural gas, as well as against air, water, and land pollution. And *third*, the period of the 1980s when U.S. policy is to use the oil industry to balance the Federal Budget. This is the most dangerous period because the first two periods have weakened the industry and left it less resilient to carry on under new taxes and controls. The Federal Government has changed the oilman, who was a great risk-taker, into a lawyer and lobbyist, who spends more time in Washington than in the oil patch.

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We went through a so-called "energy crisis" during the Arab oil embargo, and during the 1970s U.S. oil production declined under Federal controls, but there was no great fear of the exhaustion of domestic reserves. Quite the contrary! Since the 1950s, when independent producers pleas were against the entry of "cheap foreign oil," the U.S. oil industry has assumed that improved technology, deeper drilling and enhanced oil recovery, as well as opening up Federal lands, and offshore leases, would carry us into the twenty-first century.

People on the same side can look at a problem like the recent precipitous decrease in the price of oil and see different solutions. The first side believes that an oil import tariff would damage our national security. The other side calls for a "national security" tariff on oil imports. Mack Wallace, Commissioner of the powerful Texas Railroad Commission that regulates the petroleum industry in Texas, for more than a year has spoken out in favor of oil import fees. The Texas Independent Producers and Royalty Owners Association (TIPRO) also support an import tariff.

Texas raised the cry for oil import quotas in the 1950s. At that time, Eisenhower was President, Johnson was Majority Leader in the Senate, and Rayburn was the Speaker in the House - all from Texas! President Eisenhower heard the cry and issued a proclamation, the Mandatory Oil Import Program, on March 10, 1959. The most direct result of the Federal import quotas was the creation of OPEC in 1960 and the involvement of the Federal Government in the oil patch. For the American consumer, it added up to increasing energy costs along with declining reserves of petroleum.

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The MOIP served to prorate cheaper foreign crude oil through quotas. In this manner, federal and state governments managed to control production and competition. In 1969, the Department of the Interior estimated the cost of "protecting" domestic oil production at about $2 billion a year. Others (Douglas Bohi and Milton Russell) contend that the program added $5 billion to direct fuel costs in 1969 alone.

Besides the burdensome bureaucracy that had to administer the programs, granting the licenses (tickets) and handling the policy issues (special exemptions) within the quota system, MOIP led to increased imports of residual fuel oil, and domestic refineries thus increased their gasoline production as they cut back on resid.

MOIP was called a national security matter! Earlier in 1955, the U.S. unsuccessfully applied voluntary restrictions. Oil was "being imported into the United States in such quantities as to threaten to impair the national security." In April 1957, the director of the Office of Defense Mobilization certified to the President that there was a threat to national security from oil imports. The MOIP took care of this national security problem!

Now, please note that the MOIP quota system was finally scrapped on April 18, 1973. Few remember this date. However, the October 1973 War and the Arab oil embargo is still fresh in everyone's mind. Hardly a newspaper or journal is printed in this country that does not daily mention the villains who perpetrated this unfair act on our country.

That we could be so angry because we could not buy oil from those whom we had denied entry to our markets for 15 years is mind boggling. It was one of the greatest American boomerangs. However, few in the United States grasped the connection between 1959 and 1973.

This is all so confusing for most citizens. Even for Congress sometimes, who not knowing that the embargo was applied only by the Arab members of OPEC, simply punished all the members of OPEC by withdrawing OPEC from the preferential tariff system accorded to developing countries. The non-Arab members of OPEC did not participate in the embargo - yet they were punished by the U.S. This was an illogical retaliation for increasing oil production and helping the U.S. in a time of crisis.

Yes, national security is indeed at issue. But it should not be raised for the wrong reasons, such as a flag for certain domestic oil producers, to the detriment of the common good - the nation and our allies. Presently, there may be a surplus of supply over demand for both oil and natural gas, however, there is a shortage of proven reserves, and this should give us great concern! Replacing petroleum reserves is the problem the U.S. should be concentrating on - not how to tax the oil industry in order to balance the Federal Budget!

The continuing growth in the U.S. trade deficit is a result of foreign exporters seeking higher profits through higher quality/cost products rather than a maximum market share of the U.S. market. The best example of this is the Japanese automobile exports to the U.S. after the U.S. applied quotas to Japanese car imports. The rest of the world shifts its exports because the U.S. is the largest market.

The international oil market is shifting back to a more traditional market of oil product exports. When the U.S. was the largest exporter of oil, we didn't export crude, we exported kerosene and other products. When Russia was the world's largest oil producer in the nineteenth century, they too exported products. Refineries were built near the oil fields. Once more, the U.S. is exporting oil products, and these new exports would be hurt by an oil import fee.

If you pass an oil import tax on oil, you will once more distort the energy industries in the U.S., and in a very short period make the U.S. even more dependent on foreign imports, and give OPEC even more leverage than it had in the 1970s in setting the price of oil.

Furthermore, an oil import fee/tariff would create a new "entitlements bureaucracy." The oil fees would have a new group of beneficiaries, e.g.: Northeastern consumers of heating oil, certain small refiners, the petrochemical industry, farmers, our armed forces that consume about 200 million barrels of petroleum products a year (U.S. Air Force consumes over half of this). In the end, the expected revenues from an oil import tariff will not materialize. The Windfall Profit Tax is a fine example of dashed expectations.

It has been stated before and I will repeat: consumers pay for tariffs or taxes. Since tariffs and taxes misallocate capital and labor, they encourage the inefficient operation of an industry and inevitably make a country less competitive in world markets. And since tariffs cause harm and hardship in other countries, they encourage reciprocal actions. Canada, Mexico and Venezuela are our major sources of oil imports. Canada helped us through the Arab oil embargo and the winter freeze of 1977. Mexico has supplied over one-third of our oil for the Strategic Petroleum Reserve and has a crushing foreign debt. These neighbors would be harmed by a U.S. oil import fee. Tariffs or import quotas can turn into behemoth boomerangs.

LOUISIANA ECONOMIC ACCELERATION PROGRAM

(LEAP)

PROPOSAL

BY

SENATOR SAMUEL B. NUNEZ, JR.
PRESIDENT
LOUISIANA SENATE

PROPOSAL PAPER PREPARED BY

LORI CAMERON
COUNSEL TO THE PRESIDENT

NOVEMBER 25, 1985

MEETING THE CHALLENGE OF LOUISIANA'S ECONOMIC CRISIS

The close of 1985 finds Louisiana in economic crisis. The state's staggering unemployment rate, which is second only to West Virginia's, and the chronic deficit posture of state government, are indicators of its condition.

The crisis is an immediate problem. The crisis must be considered however, in the context of Louisiana's limited, and weakened, economic base. Future crises may only be averted by directing the state's attention to creating a stronger, diversified economy.

The Louisiana Economic Acceleration Program (LEAP) proposes to create immediate employment opportunities, accelerate the state's economic recovery, and begin work on long-term economic diversification.

There are a multitude of statistics quantifying the extent and cost of unemployment to the state's economy. It is impossible however to quantify the effect on Louisiana's citizens and their families. The cost to the state's spirit is as unacceptable as the cost to the economy.

Unemployment is a double burden on the state's economy. People without jobs drain the state's coffers directly in the form of unemployment, health, and medical benefits. During 1985 unemployment benefits will cost the state's economy about 450 million dollars. That figure does not include amounts spent on social services for the unemployed.

However, the greater burden to the economy relates to the fact that the unemployed cannot pay taxes or spend money to support expanding economic activity. No jobs, no tax revenues, no economic growth.

There are more than 215,000 unemployed people in Louisiana today. That is more than the population of Shreveport. It is about three times the population of Lake Charles.

Unemployment in Louisiana over the first eight months of 1985 averaged 11.6 percent. This is in contrast to the national average of 7.4 percent for that same period. Three-fourths of Louisiana's parishes (48 parishes) had unemployment rates in excess of 10 percent. One in five of the parishes (13 parishes) had unemployment rates over 15 percent.

Especially troubling is the state's inability to break out of the highest unemployment ranks. Over an 18 month period from the beginning of 1983, the national unemployment rate fell steadily from 10.4 percent to about 7 percent where it has remained through mid-1985.

Louisiana has shown no sign of sharing in this national recovery. The state's unemployment rate remains stubbornly at more than 50 percent above the national average.

The second indicator of economic crisis is the perilous fiscal situation of state and local governments. Since 1983, the state has cut 277.6 million dollars in expenditures. In 1984 over 900 million dollars of new taxes were levied.

In spite of the cuts and the increased tax rates, the state faces a deficit of up to 177 million dollars this fiscal year. Parochial and local governments face similar dilemmas.

Tax increases are not the answer. Raising tax levels has a chilling effect on the economy. The purpose of the State must be to increase economic acitivity in Louisiana, to get money moving again, rather than taking it out of circulation in the form of increased taxes.

Louisiana must put her people to work, and encourage investors to put their money to work in Louisiana. An economic recovery, sparked by new jobs and investments will increase revenues for the state and restore Louisiana's sense of purpose.

LEAP is a three year program to create new jobs and revenue while accelerating Louisiana's economic recovery. LEAP establishes an Economic Diversification Fund within the State Treasury, the proceeds of which will fund economic diversification programs.

LEAP utilizes Louisiana's strongest natural resource, oil and gas, as a tool. Historically, Louisiana's state government has viewed oil and gas development as a source of direct tax revenues.

LEAP views oil and gas development as an engine to accelerate the state's economic recovery by providing cash and jobs to the state. Direct tax revenues are forgone in favor of jobs, economic activity and indirect tax revenues.

Oil and gas drilling creates jobs and cash flow throughout the economy. Initial analyses indicate that a single rig, running throughout the year, means jobs for 516 people in Louisiana.

The rig represents 172 jobs in the oil and gas exploration and production sector. Further, for every job in the oil and gas exploration and production sector there are two others created elsewhere in the economy.

Relative to cash flow, it has been estimated that an average well drilled in Louisiana costs more than a million dollars, (i.e. $1,023,079). Other studies demonstrate that for every million dollars expended in the oil and gas exploration and production sector, three quarters of a million dollars in sales occur elsewhere in the economy.

One of the most attractive aspects of LEAP is the fact that Louisiana has a knowledgeable work force ready to walk back onto the drilling sites and start operations.

There will be no lag-time training computer specialists or high tech machinery operators. Louisiana's people know how to work the oil rigs, run the seismic tests, prepare the mud, and operate the related service industries.

Anyone familiar with Louisiana's economy recognizes that overdependence on an ailing oil and gas industry is a major contributing factor to the state's current economic problems. How then can LEAP expect to improve the state's position using that same industry?

The answer lies in coaxing the entire U.S. oil and gas industry to give its best performance over the next three years in Louisiana. Although drilling activity nationally may be limited, Louisiana will distinguish itself from other producing areas and attempt to pull as much activity as possible into the state for the three year period.

The state will give producers a reason to drill in Louisiana rather than Texas, Oklahoma, or Alberta. The state will provide oil and gas investors with an alternative to "sitting next year out", and instead, encourage the investor to risk drilling capital in Louisiana.

In order to understand the elements of the LEAP proposal, it is important to understand the status of the oil and gas industry. It is not a healthy industry. In the closing days of October 1985, drilling activity was down 27 percent nationally, from the year before. Dismally, Louisiana's drilling was down 31 percent for the same period. Industry forecasts indicate further declines in drilling activities for 1986.

Similar drilling declines over the last five years have affected Louisiana tremendously. Since 1981 the state has lost over 19,000 jobs in oil and gas exploration and production. The multiplier would suggest that another 38,000 jobs were lost throughout the economy, for a total of 57,000 jobs.

Severance taxes in Louisiana have also decreased every year since 1981. Severance tax revenues this year are expected to be down more than 25 percent or 250 million dollars from five years earlier. The downward revenue trend is expected to continue.

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The reasons for the drilling declines are varied. Basic to an understanding of the problem is a recognition that the oil market is distinct from the gas market and they face differing market situations.

The market for oil is a world market, tied together by tankers transporting crude from producing nations to consuming ones. Despite internal problems, OPEC maintained its power to influence the world price for crude oil throughout 1985. A premium commodity, Louisiana sweet crude has sold at about $28 per barrel all year.

The demand for crude has likewise remained stable. Louisiana producers report that they can sell crude oil, if they are willing to take the world-dictated price. The lower price has caused a decrease in drilling activity throughout the nation, as investors opt for alternative investments or wait out the lower price.

Unlike the relatively stable, though depressed, crude oil market, the market for natural gas is in shambles. Despite prices at a fraction of what they were three year ago, an excess of supply exists.

The market for natural gas is limited to North American producers and primarily American consumers. The market's geographical boundaries are defined by pipelines, since pipelines are the only economical means of transporting natural gas.

Over the last few years, the price of natural gas has plummeted. Some Louisianians recall Tuscaloosa Trend gas contracts signed in the early 1980's for $8 per Mcf and more. In contrast, the November 1985 spot market price for Louisiana natural gas was $2.03 per Mcf.

Higher natural gas prices in the early 1980's led to more production at the very time consumers began to implement serious conservation efforts. Increased production led to increased supply while conservation led to decreased demand.

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These factors combined to spawn an oversupply of natural gas, originally referred to as a "bubble" of excess deliverability. The excess supply of natural gas causes producers to fear that even if they find gas at competitive prices (i.e. in the $2 per Mcf range) there will be no buyers for the new gas.

Producers see the consuming end of the market as saturated with gas. Unless market demand can be expanded, there is no reason to drill for gas not expected to sell. This is particularly true given today's extremely competitive price structure where profit margins have been shaved thin.

The differing market situations facing crude oil and natural gas require a different combinations of incentives to promote increased drilling activity in Louisiana. Oil producers need to see an improved bottom line to entice them to move drilling activites to Louisiana, or indeed to commit investment dollars to drilling anywhere.

Natural gas producers need encouragement at both ends of their market before they will commit to drill. On the producing end they need to feel that there is an opportunity to be competitive in the cutthroat national price battle.

On the consuming end, they need to see expansion of demand for natural gas, either from new consumers or increased takes by present consumers. Expanded demand will assure producers that there will be buyers for gas from new wells.

In addition to the market pressures described, there are a number of factors outside of the market framework, each of which has the potential to profoundly affect drilling activity in the United States. They are declines in the world price of oil; changes in federal laws, (e.g. an abandonment of tax credits for oil and gas operations under the Tax Simplification Plan); and federal regulatory changes, (e.g. the Federal Energy Regulatory Commission's (FERC) proposed block billing regulations).

These factors are largely outside of Louisiana's control although pressure may be exerted on the congressional and regulatory fronts. However, these factors should affect all producing states uniformly. Therefore, if Louisiana distinguishes itself through a state incentive program, it will maintain an advantage.

It should be noted that Outer Continental Shelf (OCS) activity is unrelated to onshore Louisiana. At present, OCS development is driven largely by federal lease considerations. In 1983 the federal government held its first, record-breaking, area-wide lease sale. Blocks of OCS acreage were leased by the federal government for millions of dollars.

Recently there has been minimal activity on these leased blocks because of depressed market conditions. However, under the terms of the lease, if exploratory activities are not underway by the conclusion of the lease period, all rights under the lease will be lost.

Since the normal term of these leases is five years, increased OCS activity may be expected in 1987 and 1988 due to lease pressure. This activity is independent and outside of state influence.

The following section presents the elements of the LEAP proposal. The third section discusses estimated impacts attributable to the proposal and the fourth section deals with state policy, the industry, and LEAP.

ELEMENTS OF THE LOUISIANA ECONOMIC ACCELERATION PROGRAM PROPOSAL

The LEAP proposal ties short-term economic acceleration to long-term economic diversification in a comprehensive package. The LEAP proposal is for a three year period, which is assumed to begin upon the enactment of the enabling legislation. During the program period, exploratory oil and gas wells drilled in new fields, and all subsequent developmental wells in the same field, will qualify as LEAP wells. There are three major elements of the LEAP proposal.

The first deals with the suspension of oil and gas severance taxes, as well as the state's natural gas royalty, on production from LEAP wells. Producers applying for such benefits would be required to certify that Lousiana labor would be utilized to the maximum extent possible. The severance tax provisions would be administered by the Department of Revenue and Taxation. The royalty provision would be administered by the Mineral Board.

The second element deals with state incentives for the consumption of natural gas produced from LEAP wells. The state would provide an incentive of X cents per MCF for such gas consumed in excess of the consumer's 1985 baseline consumption. This incentive will assure a market for natural gas produced from LEAP wells.

The amount of the consumer natural gas incentive remains to be determined. It will be established prior to drafting of enabling legislation, based on discussions with market participants.

The incentive would be paid to qualified consumers at the end of the program year. Applicants for the incentive would certify as to their 1985 baselevel of natural gas consumption, as well as their increased consumption during the program year. Further, documentation would be required as to the origin of the LEAP gas.

The natural gas incentive aspect of LEAP will be structured so that Louisiana industrials and utilities are qualified applicants. LEAP will further provide that all incentives received by a utility serving end-users (i.e. residential and commercial customers) be passed through to those end-users. The natural gas incentive element of the program will be administered by the Department of Revenue and Taxation.

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The third element deals with an Economic Diversification Fund, which would be established within the state treasury. During the program period, the Fund would receive all state oil royalties from LEAP wells. At the conclusion of the program period, all future severance taxes and royalties from LEAP wells would accrue to the Fund.

The Fund would be the source of revenue for natural gas incentive payments during the program period; remaining revenue in the Fund could be appropriated to economic development programs. At the conclusion of the program period, the Fund would be utilized to support long term economic diversification program plans developed over the three year period.

All appropriations from the Economic Diversification Fund will be designated as such in the state budget. Long term economic diversification program plans will be developed during the three year program period and defined in legislation. Once codified in the statutes, long term economic diversification programs will be eligible for appropriations from the Fund.

Existing production, as well as severance and royalties accruing from existing production (approximately 1.2 billion dollars) would be unaffected by LEAP.

ANALYSIS OF IMPACTS OF THE LEAP PROPOSAL

The LEAP proposal is designed to maximize speedy employment and investment response. Although more thorough studies are underway, initial calculations approximate the impact of the program.

Pending verification with econometric models, the state may expect that an increase of 200 exploratory wells as a result of LEAP, over one program year, may provide 10,000 new jobs, $15.2 million in increased revenues to the state and $360 million in increased personal income in Louisiana in the program year.

Suspension of the severance tax on LEAP wells for the three year program period is an ideal incentive to encourage speedy response. Suspension of severance tax offers producers immediate price relief on oil and gas from new Louisiana wells, improving the producer's cash flow situation from earliest production.

Since virtually all producing states have severance taxes, suspension of the tax on new production is a clear means of distinguishing Louisiana as the state of choice for drilling activities. Severance taxes are built into the producer's economic analyses of nationwide drilling prospects. Suspension of the tax in Louisiana will have a decided impact on the bottom line, drawing drilling capital from around the country.

The severance tax provisions of the proposal are also in line with the Program's goal of minimizing cost to the state. Realistically, the current oil and gas markets go a long way toward minimizing the cost of severance forgone. If producers don't drill there will be no new severance tax revenues to forego.

Severance tax and royalty revenues from production existing prior to LEAP's start would continue to be collected by the state. The only tax revenues foregone would be those from LEAP wells.

Revenue losses from wells that might have been drilled without LEAP's encouragement will be offset by increased revenues attributable to economic activity generated by LEAP. Drilling investments will have expansive affects on the economy. The re-employed will be paying income taxes, sales taxes as well as other taxes. Further, they will no longer be draining state coffers but rather, contibuting to them.

Natural gas royalties on state-owned production from LEAP wells will also be foregone by the state. This additional incentive is offered to natural gas producers in recognition of the more depressed natural gas market.

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There is a cost of LEAP not mentioned in the impact analysis. That is the long-term cost of encouraging present use of Louisiana's finite natural resources. This cost is incurred by the LEAP in consideration of the state's present economic crisis. Certainly Louisiana does not have to wait until it is dead last, rather than 49th in unemployment before utilizing its strongest assets.

In order to assure maximum employment, each application for severance tax and royalty forgiveness will include a labor certification. The producer will certify that Louisiana labor has been used to the maximum extent possible in exploration and production of the oil or gas.

The second major element of the program is an incentive payment to encourage additional consumption of natural gas by Louisiana consumers. Revenue for the incentive payments will come from state crude oil royalties accrued from new production activities spurred by LEAP.

In other words, if LEAP works, it will pay for the natural gas incentive itself. If LEAP does not work, there will be no additional gas to be consumed, no incentives to be paid, and so, no cost to the state.

The incentives are necessary because of economic disorder in the natural gas market, nationally as well as in Louisiana. Even at nationally competitive prices, Louisiana producers cannot find markets for new natural gas.

In order to assure that producers of natural gas drill in Louisiana, creating the jobs and attendent economic benefits to the state, the state will endeavor to provide additional markets for natural gas. Market expansion will be encouraged by offering incentives to Louisiana consumers to buy additional amounts of natural gas from new wells in the state. Utilities will be required to pass through benefits to residential and commercial customers.

In addition to assuring a market for new Louisiana gas, the incentive program will assure that Louisiana's natural gas-consuming industrials remain competitive in fierce national and international markets. Those Louisiana jobs will be protected as well.

In order to qualify for incentives at the end of the year, the natural gas consumer (industrial or utility) will apply to the Department of Revenue and Taxation. The application will certify the consumer's 1985 baseline consumption, the amount of natural gas used in excess of the baseline during the program year, and provide documentation as to the purchase of gas from LEAP wells in an amount equal, at least, to the excess consumption.

The third major component of the program is proposed in recognition to the state's critical need to develop a diversified economy as part of a long-term economic development plan. LEAP addresses the crisis as well as the underlying weakness, by providing a planning and funding mechanism with which state may implement long-term economic diversification plans.

At the conclusion of the three year program period, severance taxes and natural gas royalties will be levied on future production from wells drilled under the auspices of the program.

These severances and royalties from increased production attributable to program incentives will accrue to the Economic Diversification Fund and be dedicated implementing long range economic diversification plans.

The three year LEAP period may be utilitzed for developing economic diversification programs. The plans should be developed as legislatively-approved programs, their purpose and approach set down in the statutes.

At LEAP's conclusion the Economic Diversification Fund will receive the revenue benefits of increased production. At that time, appropriations may be made, and identified as such, to the economic diversification programs.

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If, during the program period, the Fund has revenues remaining after the payment of natural gas consumer incentives those monies may be appropriated to existing economic development programs. For example, the Small Business Development Act of 1984 would be an excellent candidate for an appropriation from the Economic Diversification Fund.

LEAP is limited to three years for a number of reasons. Foremost among the reasons is that the state of Louisiana cannot afford to continue its economic dependency on oil and gas.

The second reason for the Program's three-year term is that it will take at least that long for Louisiana to take its place among its economically active sister states. A recovery from 49th in unemployment will take longer than a few months.

The third reason or set of reasons concerns the oil and gas industry. A three year period is long enough to fully attract the attention of producers nationwide. Also, many experts feel that a revival of the oil and gas industry may be expected in three year to five years. If this is the case, Louisiana will be poised and ready to take full advantage of the industry's comeback.

LEAP has a number of program requirements to assure that employment and revenue benefits are safeguarded. First, producers applying for severance tax and natural gas royalty relief will have to prove that the well in question was drilled and completed during the program period. This may be done with the Office of Conservation permits which are required prior to drilling.

The producer will also certify that Louisiana labor was utilized during exploration and production activities to the maximum extent possible. This certification will be similar to one required by the state's bonding authority with regards to state funded projects.

Second, industrial and utility consumers of natural gas will have three tests to meet in applying for consumption incentives. They will have to certify 1985 baseline consumption of natural gas, certify the amount they use in excess of the 1985 baseline, and show with purchase certificates that the excess amount for which the incentive is sought was purchased from LEAP wells.

Producers will certify LEAP well sales to pipelines, who will certify the same to consumers. Since well production figures and transportation data are currently kept by the Office of Conservation, the Program's impacts will be easily verified.

Residential and commercial consumers will not be troubled by the verification procedure. Utilities, both private and public, which supply residential and commercial consumers will meet the program certification requirements and be required by statute to automatically pass through benefits to the end-user.

As a final safeguard, a legislative committee appointed by the Speaker of the House and the President of the Senate would be give legislative oversight authority for the program. The committee would be authorized to order program audits where indicated.

LEAP, STATE POLICY AND THE INDUSTRY

LEAP will help reshape Louisiana's business image nationally. It sends a clear message: Louisiana wants you and your dollars doing business in Louisiana.

Equally important, it will send a message to the citizens of this state that Louisiana has the willpower and the ingenuity to deal with problems facing the state. This is a state of people wanting and ready to work and a government prepared to give them that opportunity.

Given the critical nature of Louisiana's employment and fiscal situation, LEAP is designed to encourage quick response from the oil and gas industry. Because severance taxes and natural gas royalties will be suspended only for the three year program period, wells drilled early in the program period will reap the most benefit.

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Industry conditions also assure quick response. About 80% of "wildcat" or exploratory wells are drilled by "independents", small oil and gas producers. Major oil and gas companies like Exxon, Texaco and others are responsible for the remaining 20 percent.

Today, like many other relatively small businesses, a number of independents facing severe cash flow problems. Drilling under LEAP's terms will offer some immediate relief to their cash flow situtation.

Banks, and other leading institutions to whom Louisiana independents are indebted, may also be interested in LEAP. If banks foreclose, they get little besides equipment. If they give the producer "another chance" there may be an improvement in his overall financial condition.

Loans to finance new wells with guaranteed lower costs (e.g. severance tax forgiveness) are relatively attractive risks. LEAP should be welcomed by lenders, as well as by independents.

The majors find themselves in a different situation. Majors generally have investment capital but may, because of corporate diversification, may have better alternative investments. LEAP may provide the majors with the incentive necessary to invest in drilling in Louisiana.

Finally, because drilling is off, drilling equipment and services are readily available at very reasonable costs. Given incentives beyond those available in the market place, it's a good time to drill for oil and gas.

Further, with regard to the oil and gas industry nationally, LEAP will leave Louisiana well-positioned. The state's oil and gas producers will be activated and able to quickly and easily increase production to meet demand as the market recovers nationally.

It is expected that both shallow and deep wells will be drilled under the auspices of LEAP. In terms of employment benefits to the state, it does not appear that either shallow or deep wells are markedly more advantageous. A number of shallow wells, each employing a drilling crew, can be drilled over the same time period it takes to drill a single deep well. In addition to a longer employment term for the crew, a deep well will require more equipment and services (and related employment) like specialized mud, pipe, and drill bits.

From the producer's standpoint, the program should be attractive for either type of well. Shallow wells cost less to drill and so an incentive (a 7 cent per Mcf cost reduction) may have a dramatic affect on the "bottom line." On the other hand, deep wells generally produce more, multiplying the impact of an incentive.

LEAP should have little impact on existing oil and gas production in the state. This largely because drilling activity is financed by lenders who are repaid with proceeds from the well's production. In order to pay for a well, it must be kept in production.

In the case of an older well that has already paid out, it is likely to be producing oil or gas the producer can afford to sell cheaply. The producer will want to maintain that production in order to lower his average sale price. Further, impacts on existing natural gas production should be minimized by the market expansion generated in Louisiana for new gas by the state's consumer incentive. Similarly, there should be little impact on the national oversupply situation.

There may be concern that producers might cap existing wells and drill new wells into presently producing pools in order to avoid severance taxes. This concern may be addressed on regulatory and economic grounds.

First, the State's Office of Conservation keeps track of all wells drilled in Louisiana. Attempts to drill in presently productive pools will be quickly recognized.

Second, it is unlikely that a producer would expend the capital, on average of a million dollars, to drill a new well in a producing field just to get a severance break. There are no geophysical guarantees that production will be resumed with the second well.

No other state has undertaken an initiative similar to LEAP. Other states do not have Louisiana's combination of economic problems and geological conditions that favor the response expected in Louisiana.

However, the Canadian government, along with its oil and gas producing provinces, have embarked on a related program. Changes in Canadian energy policies brought about a 21 percent increase in oil sales to the U.S. and a 27 percent increase in gas sales over a six month period.

Canada's situation differs from Louisiana's; Canadian provinces own the mineral resources within their boundaries. Not surprisingly, Alberta which produces 85 percent of Canada's oil and gas, is anxious to take advantage of the employment and revenue advantages of increased production.

In the spring of 1985, the Canadian federal government reached an agreement with the oil and gas producing provinces of Alberta, Saskatchewan and British Columbia termed the Western Accord. The Western Accord called for increasing energy investments and creating additional jobs through decontrol of crude oil prices, a policy of deregulation of natural gas, and a phase-out of the petroleum and gas revenue taxes. The province of Alberta has also lowered its royalty substantially to increase employment and investment.

Given the Canadian's recent policy stance, Louisiana competes even for dollars that might otherwise go to Alberta or Saskatchewan. In order to achieve its employment and fiscal purpose, the state must distinguish itself as the premier location for drilling investment in the Northern Hemisphere. Louisiana is indeed fortunate that the most critical factor, the excellent natural resource base has preceded the state by millions of years.

The state needs only to create an economic atmosphere. LEAP sets the tone. Louisiana wants the jobs and the dollars and is willing to sharing the risk to get them.

QUESTIONS AND ANSWERS ON THE LOUISIANA ECONOMIC ACCELERATION PROGRAM (LEAP) PROPOSAL

1. Why does Louisiana need LEAP? Louisiana is second only to West Virginia in unemployment and is facing a state deficit despite budget cuts and increased taxes. These crisis conditions are indicative of a weak state economy.

2. What is LEAP's purpose? LEAP is designed to accelerate Louisiana's economic recovery, easing unemployment and fiscal problems, while providing planning and funding mechanisms for long-term economic diversification.

3. Why utilize Louisiana's oil and gas resources, especially in light of the weakened condition of the oil and gas industry? In order to work, LEAP needs an industry that can quickly provide jobs and investments in exchange for state incentives. LEAP targets oil and gas drilling because Louisiana's resource base is proven and there is a knowledgeable, trained workforce ready to walk back onto drilling sites and start operations. There will be no lag-time training computer specialists or high tech machinery operators. Louisiana's people know how to work the oil rigs, run the seismic tests, prepare the mud, and operate the related service industries. There is also an abundance of idle drilling rigs, equipment, and service companies.

4. What are the elements of LEAP? LEAP is a three year program. During the program period exploratory oil and gas wells drilled in new fields, and all subsequent wells in the same field, will quality as LEAP wells.

First, severance taxes and the state's natural gas royalties on LEAP wells will be forgone for the program period.

Second, Louisiana's natural gas consumers will receive an incentive from the state of X cents per Mcf for consumption of gas from LEAP wells consumed in excess of 1985 consumption levels.

Third, the Economic Diversification Fund will be established to pay for the natural gas consumer incentive during the program period and to provide revenues for long-term economic diversification programs at LEAP's conclusion. State oil royalties from LEAP wells will be dedicated to the Fund immediately. At the end of the program period all severance taxes and royalties from LEAP wells would accrue to the Fund. Existing production and related revenues are unaffected by LEAP.

5. Why suspend the severance tax? Suspension of severance tax is the one area that the State controls which can have an immediate positive impact on the marketability of Louisiana oil and gas. The suspension of severance allows the "bottom line" on many wells to shift from marginal to positive, thus spurring drilling activity. It also improves the producer's cash flow situation from earliest production, when such relief is needed most.

6. Why suspend natural gas royalties and offer additional incentives on the natural gas marketing end? The incentives are necessary because of the current economic disorder in the natural gas market, nationally as well as in Louisiana. Suspension of the severance tax and gas royalties from state lands on natural gas will encourage producers to drill. However, further incentives will assure that there are buyers for LEAP gas.

7. How is Louisiana assured of long-term benefits from LEAP? The Economic Diversification Fund will provide revenues dedicated to the implementation of long-term economic diversification plans. Such plans will be developed over LEAP's three year period and defined in the statutes in order to be eligible for appropriations from the Economic Diversification Fund. The Fund is the State's way of announcing that all revenues generated from LEAP wells are forever dedicated to the diversification and expansion of Lousiana's economy.

8. What safeguards will be built into this program to ensure that employment and revenue benefits are realized? First, producers applying for severance and royalty relief will have to prove that the well in question was drilled and completed during the program period and is in a new field. This may be done with the Office of Conservation permits which are required prior to drilling. Secondly, the producer will certify that Louisiana labor was utilized during exploration and production activities to the maximum extent possible. This certification will be similar to one required by the state's bonding authority with regards to state funded projects. Applicants for consumer natural gas incentives will certify 1985 baseline consumption, excess consumption for the program year, and document that excess consumption amounts come from LEAP wells. Finally, a legislative committee will be appointed to give legislative oversight of the program, with authoriztion to order program audits where indicated.

9. Will there be a quick response to the program? Industry conditions assure a quick response. Because severance taxes and natural gas royalties will be suspended for only a three year period, wells drilled early will benefit the most. Additionally, many independent producers (the group responsible for the vast majority of exploratory drilling) are facing severe cash flow problems. Immediate drilling and production will provide some relief to this situation. Also, drilling equipment, and service costs are currently very low, thus creating additonal incentives to drill now.

10. Why limit the program to three years? First and foremost the state cannot afford to continue its economic dependence on oil and gas. Second, it will take at least that long for Louisiana to become competitive with its economically-active sister states. Third, three years is sufficient time to attract the attention of producers nationwide. Also, many forecasters predict the revitalization of the oil and gas industry in the next three to five years. In this case, Louisiana will be poised and ready to take full advantage of the industry's comeback.

11. What will LEAP cost the state? The cost of LEAP will be the long-term cost of encouraging present use of Louisiana's finite natural resources. This cost is incurred by the LEAP in consideration of the state's present economic crisis. Certainly Louisiana does not have to wait until it is dead last, rather than 49th in unemployment before utilizing its strongest assets.

12. What employment and revenue impacts may be generated by LEAP? Pending verification with econometric models, the state may expect that for every increase of 200 exploratory wells as a result of LEAP, over one program year, may provide 10,000 new jobs, $15.2 million in increased revenues to the state and $360 million in increased personal income in Louisiana during the program year.

13. How will the proposed program affect the state's business image? It will send a clear message that "Louisiana wants you and your dollars doing business in Louisiana". Equally important, it will send a message that Louisiana has the willpower and the ingenuity to effectively deal with its problems.

14. Have other governments taken similar steps? No other state has undertaken a program similar to LEAP. However, the Canadian government, along with its oil and gas producing provinces, has embarked on a related program. Changes in Canadian energy policies brought about a 21 percent increase in oil sales to the U.S. and a 27 percent increase in gas sales over a six month period. Additionally, active rig counts have increased markedly.

15. What can Louisiana do about national and international factors influencing the oil and gas market? There is nothing Louisiana can do to affect the world market. Other factors, like FERC regulatory controls and proposed congressional tax law changes, are subject to state pressure. Louisiana's story must be told at every opportunity.

16. Is this proposal a final one? This proposal is by no means a final one. This proposal is presented as such, in the belief that public discussion and recommendations can only strengthen it. Construtive criticism and suggestions are, by means of this proposal paper, actively solicited from the citizens of Louisiana, as well as those who presently, or may in the future, do business in our state.

STATEMENT OF MACK WALLACE, COMMISSIONER, RAILROAD COMMISSION OF TEXAS, AUSTIN, TX

Mr. WALLACE. Mr. Chairman and members of the committee, my name is Mack Wallace and I am the senior member of the Railroad Commission of Texas, the State agency which, among other things, regulates the exploration and production of oil and gas and the transportation for sale of natural gas to the consumers of Texas. Our agency regulates the production of about 30 percent of the natural gas consumed in this country and about 30 percent of the crude oil.

I have seen eight Secretaries of Energy come and go. I have filed with the committee my formal statement for the record; and for the time I am permitted to address this committee, I will make the following points. The United States is in a most grievous situation. Current prices for crude oil are well below reserve replacement levels. If present conditions continue, and they will unless we choose to reverse them, we will lose fully one-third of this Nation's producing capacity within 4 years. When that occurs, we will find ourselves in a position of greater dependence on imports than in the darkest days of the 1970's.

I don't think any of us want to relive that. Seventy-five percent of the crude oil and products produced in the world today is produced by governments and not oil companies. The production, transportation, and distribution of oil and gas then becomes an instrument of foreign policy. Since 1972, the United States has spent more than $549 billion for imported crude oil and crude oil products. The United States has reserves of about 27 billion barrels, while north Africa, Saudi Arabia, and other Mideast countries have reserves of 433 billion barrels.

My question is: How can a 12 barrel a day well in the United States compete with a 40,000 barrel a day well in Saudi Arabia produced from a government lease with substandard labor? The Saudis can alone control the price of world crude, as they demonstrated in 1973, and as they are further demonstrating today. In east Texas, we learned in grammar school a simple phrase: Fool me once, shame on you; fool me twice, shame on me.

Unless the administration and the Congress develop a national energy plan which addresses the situation with an import tax, we will face severely dwindling supplies for our national security. Such an import fee can be the cornerstone of hopefully bipartisan domestic energy policy for which all could share responsibility. We simply cannot continue as a democracy without fuel. Surely, the domestic ability to produce oil and gas is as important to the Nation as a 25 percent tariff on asparagus or a 31 percent tariff on wool lace. Mr. Chairman and members, America's domestic ability to produce oil and gas cries out for stability.

With the threat of tax reform and removal of incentives from the production sector, along with the Saudi control of the world market, I believe that an imposition of a variable tariff on imported crude oil and crude oil products is an essential step in that direction. And Mr. Chairman, if I might indulge for just a moment, I want to compliment you on analyzing the Saudi intent, for they have published it for years and they have followed exactly what they said they intended to do. And it was a promise made by Sheik Yamani in Cairo in 1984 that prompted me to appear before the New York Times editorial board in December 1985 and discuss the import tax question with them.

And in February of that year, they wrote their first lead editorial urging an import tax on that product and have written five or six since. And here is the statement: Arab oil will again—they made this statement in Cairo in 1984 in the month of April—become a political weapon by 1987 because the Western world cannot live without it, said Saudi Arabia's oil minister, Sheik Yamani; and they have done exactly what they intended to do. And he is using 1987 as a benchmark because he is aware of our production in this country, as we are aware of it; and the price drop that they have imposed is the first shot in his political war with the use of crude oil. Thank you, Mr. Chairman.

Senator **WALLOP**. Thank you, Mr. Wallace.

Mr. Wishart?

[The prepared written statement of Mr. Wallace follows:]

TESTIMONY
OF
MACK WALLACE, SENIOR MEMBER
RAILROAD COMMISSION OF TEXAS
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE
WASHINGTON, D.C.
FEBRUARY 28, 1986

Mr. Chairman:
Members of the Committee:

My name is Mack Wallace. I am the senior member of the Railroad Commission of Texas, the state agency which, among other things, regulates the exploration and production of oil and gas and the transportation and sale of natural gas to the consumers of Texas.

I am most pleased to have this opportunity to submit testimony on what I consider to be a crucial issue: The need to impose a tax on crude oil and crude oil products imported into this country.

I

Let me begin by being blunt. We must take swift action to extricate this nation's energy base from its current nose dive into subjugation under the direction of foreign governments.

Presently, we are losing the "energy war" by default.

Recent events of the past few days, weeks and months affecting this nation's energy position in the world should be cause for grave concern to all Americans.

I am convinced we are witnessing an approaching tragedy with staggering consequences that threaten not only our economic stability but our national security as well.

These events impinge directly on the ability of the United States to search for and produce the natural resources that are absolutely essential to our national interest.

II

The jeopardy we face is dramatically illustrated by looking at current drilling information -- drilling activity in the United States has fallen to levels not seen in the last 10 years.

A total of 7,419 permits were issued to drill for oil and gas in the United States during the month of January -- a decline of 13.3 percent from the comparable period in 1985. New field wildcat permits issued for the month numbered 636 -- down more than 28 percent from one year ago. Other exploratory permits -- drilling in and near existing fields -- totaled 731, a decline of more than 30 percent from the January, 1985 total.

There is more oil and gas yet to be found and produced in America -- lots more with our improving technology -- but not under the present circumstances of foreign manipulation, coupled with the lack of a long-range national energy policy.

Our imports of crude oil and products, on the other hand, are creeping upward and presently amount to 5 million barrels a day, roughly 30 percent of our needs. Since 1972, the United States has spent $549 billion for oil and oil product imports.

These numbers are unacceptable to me, especially at a time when our own government is also considering increasing taxes in the guise of tax reform on our energy explorers and producers.

Yet, the present administration and many in the Congress seem oblivious to the danger at hand.

Nine months ago, the Texas Legislature, by concurrent resolution, called on the President and the Congress to impose a tariff on all imports of foreign crude oil and foreign petrochemical products, declaring that the stability of America's oil and petrochemical industries is being threatened.

In the U.S., we saw our reserves of oil and gas decline in the 1960's. We saw both reserves and production decline at alarming rates during most of the 1970's, and with that decline the intolerable dependence of this country on foreign energy supplies.

With the level of drilling of the early 1980's, we added reserves equal to production and stabilized production. We now face acutely depressed drilling activity and with it the certain return to the decline and dependency of the 1970's.

III

Let me put some numbers on the decline and dependency we can expect with oil prices at $15 per barrel.

In the U.S. we have a large volume of production coming from wells with a low daily yield. In Texas, a good representative of the U.S. lower 48, more than 95% of all wells produce less than

50 barrels per day and two-thirds of all wells produce 10 barrels a day or less, the so-called stripper wells.

Obviously, production from these low-yield wells is very sensitive to price. In the U.S. a total of 1.3 million barrels per day is produced from about 350,000 stripper wells. About 400,000 barrels a day come from wells producing three barrels per day or less. At $15, the great bulk of these wells and a significant number of other more costly stripper wells, will be plugged and abandoned. In excess of 400,000 barrels a day of capacity will be lost over the next 12 months. If prices were to fall to $10, the loss would be closer to a million barrels a day.

Severely reduced cash flow at $15 per barrel will reduce oil drilling drastically, both for reserve growth and new field discovery, yielding a corresponding loss of reserve additions. While additions nearly equalled production over the past five years, the reduction in drilling at a $15 price will result in a lower 48, non-stripper production decline of about 5% annually. This translates to a production loss of 2 million barrels per day by 1990, and nearly 4 million barrels per day by 1995.

Alaskan North Slope production, now 1.7 million barrels per day and chiefly from the Prudhoe Bay Field, will go into normal decline in 1987. An annual decline rate of between 12 and 15% is anticipated. This will reduce Alaskan North Slope production to about 1 million barrels per day by 1990, and to 600,000 barrels per day by 1995. While about 1 million barrels a day of additional capacity exists in already discovered, smaller fields on

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the North Slope, production and transportation costs will make this capacity uneconomical at $15 per barrel.

IV

U.S. consumption of oil and liquids has stabilized at about 15.5 million barrels per day over the past four years, after marked declines earlier. At $15, increase in demand will be stimulated. By 1990, demand could be between 16.5 and 17.5 million barrels per day. Even at a conservative growth rate, our projected 1990 import level will be equal to the highest levels of the 1970's. By 1995, we could be depending upon imports for two-thirds of our supply.

As the free world's largest producer and consumer of petroleum, we should not allow that to happen again.

The ability of the United States -- all regions of the United States -- to provide a secure domestic energy resource base is a national issue and a strategic part of our national security.

We are all in this boat together. No purpose is served for one region of America to point to another and say, "Your end of the boat is sinking..."

I can assure you, when it comes to energy, we will sink or stay afloat together.

News stories talk about the glut of world oil being "exacerbated" by OPEC. I would declare that the present situation is not "exacerbated" by OPEC, it is "caused" by OPEC.

V

Today's shattered oil market is nothing more than the calculated result of another determined effort by the Saudi Arabians to manipulate energy exploration, production, and price; as well as thwarting development of alternative energy sources.

They are succeeding. If this OPEC scheme is not challenged now, we shall be brought to our knees once again, as we were in 1973.

I urge you, in the strongest terms possible to respond swiftly to this challenge. We must not return control of our energy destiny to unstable foreign sources.

The most important action this committee can take is to recommend the imposition of a sliding tariff on imported crude oil and crude oil products targeted at an agreed upon price.

Revenues generated would depend on the magnitude and level of the tariff.

Such revenues could be aimed at reducing this country's unconscionable deficit.

But, the long-term, primary value of such a tariff on imported crude oil and products far exceed any benefits to the budget deficit.

We will have stabilized America's ability to produce our natural resources. We will have declared to the world that we consider the exploration and production of our energy needs to be absolutely essential to our national security.

AVAILABLE

Members of this Committee, today, we find ourselves in common peril. If we are to survive, we must join in common purpose.

This nation must come together as one wheel with many spokes -- all determined to move the United States in the direction of energy production at home, which means jobs, self-reliance and national security.

For this reason, I urge this Administration and the Congress to enact as an emergency measure a "national security" tariff on crude oil and crude oil products imported into America. As I said earlier, this tariff could be a "sliding" tariff which would send a clear signal to oil producing countries that we are going to shore up our domestic capability and declare that we are prepared to protect our own reserves.

Let such a tariff become the cornerstone of a bipartisan domestic energy policy for which all can share in the responsibility.

VI

In this economic war for energy, I believe that if action is not taken now and Saudi Arabia or any other foreign government is permitted to continue to manipulate production levels and price, the first casualty in this world-wide scenario will be the United States followed by Britain's North Sea fields.

The control of energy, then, will be effectively placed for the foreseeable future in the hands of Persian Gulf producers and the West will have been dealt a crippling blow in its domestic ability to produce oil and gas.

At a national coal conference in Chicago in 1979, I warned that the energy lifeline to the West from the Persian Gulf is dangerously susceptible to disruptions from a variety of sources. I specifically named the following:

-- a rebel coup;

-- a blockade of the Straits of Hormuz;

-- an invasion of Kuwait or Saudi Arabia; or

-- an interrupted shipping lane by one of the warring nations of the African continent.

Is there anyone in this room secure in the knowledge that none of these could occur today or within one to five years?

In conclusion, let me ask you to consider these factors:

-- By virtually all reports I have received from operators, exploration and production budgets for the United States have been slashed substantially. This will effectively put this country under a drilling program that only protects lease holdings.

-- A U.S. Department of Energy proposed National Energy Plan forecasts increased reliance on oil imports into the next century. By 1990, the U.S. will be more heavily dependent on oil imports than it was before the 1973 oil embargo. A decline in domestic production is forecast.

-- Middle East and North Africa reserves of 433 billion barrels dwarf U.S. reserves of 27 billion barrels.

-- 75 percent of the crude oil and products in the world is produced by governments -- not oil companies. The production of oil and gas then becomes an instrument of foreign policy. This is clearly illustrated by the Soviet Union's decision of a few months ago to withhold the deliverability of crude oil to Western nations thereby raising the price of crude oil.

-- Approximately one-half of the U.S. trade deficit is in crude oil and product imports.

In times of danger, it has been this nation's history to rally its forces to fight for the values it considers essential to its survival.

Time and time again, the forces of the United States -- whether they be political, economic or military or from one region or another -- have joined together to deflect strikes aimed at its cherished values.

One of the most basic of those values has been American independence. And, in our modern history, one of the ways we have successfully defended our independence has been through the recognition that a secure, domestic energy resource base is a strategic part of our national portfolio.

A national goal of energy independence that assures this country a long-term, adequate fuel supply has been a long-standing one -- up until now.

Isn't it time we take the necessary steps to free ourselves from this foreign dependence?

Isn't it time we free ourselves economically and free ourselves strategically?

Must we wait for an international disaster before we take the energy steps necessary for our own national interest and security?

Thank you. I will be happy to respond to any questions you may have.

STATEMENT OF RONALD S. WISHART, VICE PRESIDENT OF PUBLIC AFFAIRS, UNION CARBIDE CORP., STAMFORD, CT, ON BEHALF OF THE CHEMICAL MANUFACTURERS ASSOCIATION

Mr. **Wishart**. Mr. Chairman, members of the committee, I am Ronald S. Wishart, vice president of public affairs of Union Carbide Corp.; and it is a privilege to appear before you again, Senator.

Senator **Wallop**. Thank you.

Mr. **Wishart**. Today, I appear on behalf of more than 1,800 companies in the chemical, petrochemical, fibers, and plastics industries to oppose a tax on oil, especially an oil import fee, whether for Federal budget deficit reduction purposes, tax reform, or for claimed national security reasons. We have reviewed S. 1997 and S. 1507 and cannot support either. Like other forms of oil import taxes, they would, one, cost the Government substantially more than the revenues they bring in; two, seriously impair economic growth; and three, devastate the international competitiveness of the chemical, fibers, and plastic industries, and export American jobs, and mark a return to massive Government intervention in the U.S. energy markets.

Recent studies by Data Resources, Inc. for CMA, the Chemical Manufacturers Association, and PEG, the Petrochemical Energy Group, show oil taxes are a particularly inefficient way to raise Federal revenues. The $5 per barrel tax on oil imports will generate approximately $10 billion in revenue, but reduced economic growth, increased unemployment, and higher inflation generated by the tax will raise Federal, State, and local governments' costs about $21 billion a year. This tax would damage the economy and increase the deficit in our view. Even if the tax were applied to all oil, both domestic and imported, net revenues would only be about 25 cents per dollar of tax. There will be strong pressures for exemptions to the tax for home heating oil, agricultural uses, and imports from Mexico, Canada, Great Britain, and Venezuela, among others, which will reduce revenues further, I am sure.

In addition, the DRI simulation of a $5 per barrel oil tax shows real GNP, investment, disposable income, and U.S. exports would go down significantly as compared to the no-tax case. The ironic result of an oil tax will be to cause serious economic harm although it is intended to strengthen the economy by shrinking the deficit. The industries I represent today will be hit twice as hard as U.S. industry generally. This is because oil and gas and their derivatives are used as raw materials in these industries in the same way the steel industry uses iron ore. These industries are also energy intensive in their fuel use despite massive strides in conservation during the last 10 years. For basic petrochemicals such as ethylene, feedstock and energy costs run to about 75 to 80 percent of the total production costs.

You know, it is definitive that basic industry in this country is energy intensive, and there is a great deal of bewailing at this present time the decline in the basic industry in the United States. What would happen with this sort of a situation—the application of an import fee of $5 on what might be a world price of $15 for oil—is you are asking the United States' basic industry to compete in the world at a 33 percent higher energy cost than their foreign competition. The number of jobs on the line is tremendous.

Look at the plastics industry, for example. U.S. direct employment among the companies making plastics products is more than 900,000. Another 1.1 million jobs are required to provide raw materials, machinery, and other supplies. These 2 million jobs created by the U.S. plastics industry account for 7.5 percent of the U.S. manufacturing work force.

Some have urged a tax on imported oil as a national security measure, but we urge you to consider the adverse impact on national security of our basic petrochemical, plastics, and fibers industries if they are forced overseas. Petrochemical-based synthetic and plastic materials are used in aircraft, rockets, military vehicles, and weapons. I am emphasizing here another aspect of national security. We have been dealing with the concern—the spectre raised in the 1970's—of the heavy dependence of Arab OPEC oil. That has been sharply diminished as the statistics suggest. Our problem today, from the national security standpoint, is a weakening of the basic industrial fiber of the United States; and I think that has to be considered in the same context as our concern about oil importation, which we have diminished to a significant extent by the increase in production in other areas of the world than the Arab OPEC and by an emphasis on our importing relationships with the Western Hemisphere countries.

I see my time is up. I do want to say also that I think there are very viable arguments about concern for the impact of Government controls. Any such import fee as this will require help for disadvantaged portions of the economy, and anyone who lived through the 1960's, as I did, and the 1970's has too fresh a memory of the effects of that to want to see it reimposed. Thank you.

Senator WALLOP. Thank you, Mr. Wishart. Tom Donohue?

[The prepared written statement of Mr. Wishart follows:]

TESTIMONY OF RONALD S. WISHART
ON BEHALF OF
THE CHEMICALS, FIBERS AND PLASTICS INDUSTRIES

Mr. Chairman, members of the Committee, I am Ronald S. Wishart, Vice President, Public Affairs, of Union Carbide Corporation. Today I appear on behalf of more than 1,800 companies in the chemical, petrochemical, fibers, and plastics industries 1/ to oppose a tax on oil, especially an oil import fee, whether for federal budget deficit reduction, tax reform purposes, or for claimed national security reasons. We have reviewed S. 1997 and S. 1507 and cannot support either. Like other forms of oil import taxes they would:

1. cost the government substantially more than the revenues they bring in;

1/ Mr. Wishart represents the following associations: the Chemical Manufacturers Association: (CMA) is a non-profit trade association whose member companies represent more than 90 percent of the productive capacity of basic industrial chemicals within the United States; The Man-Made Fiber Producers Association: (MMF) is a non-profit trade association of the producers of over 90% of all synthetic fibers produced in the U.S. Man-made fibers constitute 75% of all fibers used in the U.S.; The Petrochemical Energy Group: (PEG) is an ad hoc group of U.S. independent petrochemical producers responsible for a substantial share of U.S. petrochemical production; and The Society of the Plastics Industry, Inc.: (SPI) is a trade organization of more than 1,800 members representing all segments of the plastics industry in the U.S. SPI's membership is composed of resin manufacturers, distributors, machinery manufacturers, plastics processors, mold-makers and industry-related categories. Founded in 1937, SPI serves as the "voice" of the plastics industry.

2. seriously impair economic growth;
3. devastate the international competitiveness of the chemical, fibers and plastics industries and export American jobs; and
4. mark a return to massive government intervention into U.S. energy markets.

DEFICIT REDUCTION

Recent studies by Data Resources, Inc. (DRI) for CMA and PEG show oil taxes are a particularly inefficient way to raise federal revenue. A $5-per-barrel tax on oil imports will generate approximately $10 billion in revenue. But reduced economic growth, increased unemployment and higher inflation generated by the tax will raise Federal, state and local governments' costs about $21 billion/year. This tax would damage the economy and increase the deficit. Even if the tax were applied to all oil, both domestic and imported, net revenues would only be about 25 cents per dollar of tax. This revenue will be further reduced by exemptions to the tax for home heating oil, agricultural uses, and imports from Mexico, Canada, Great Britain, and Venezuela, among others.

In addition, the DRI simulation of a $5/bbl oil tax shows real GNP, investment, disposable income and U.S. exports would go down significantly as compared to the "no tax" case. The ironic result of an oil tax will be to cause serious economic harm, although it is intended to strengthen the economy by shrinking the deficit.

OUR INDUSTRIES DOUBLY IMPACTED

The industries I represent today will be hit twice as hard as U.S. industry generally. This is because oil and gas and their derivatives are used as raw materials in these industries in the same way the steel industry uses iron ore. These industries are also energy intensive in their fuel use, despite massive strides in conservation during the last 10 years. For basic petrochemicals such as ethylene, feedstock and energy costs run about 75 to 85 percent of total production costs. 2/

An oil import tax will make it highly disadvantageous to produce our products in this country. We will be unable to compete in foreign markets with producers who have no tax on their energy and raw materials. An import tax would also flood the U.S. market with imports from foreign producers of chemicals, plastics, fibers and finished products who have no tax to increase their production costs. The result will be lost production, shut down facilities and lost jobs. The number of jobs on the line is tremendous. Look at the plastics industries, for example.

U.S. direct employment among companies making plastics products is more than 900,000. Another 1.1 million jobs are required to provide raw materials, machinery and

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2/ The Probable Impact on the U.S. Petrochemical Industry of the Expanding Petrochemical Industries in the Conventional-Energy-Rich Nations, U.S. International Trade Commission Publication No. 1370, April 1983.

other supplies. These two million jobs created by the U.S. plastics industry account for 7.5 percent of the U.S. manufacturing workforce.

A DRI study of a $5-per-barrel import tax done for CMA last year 3/ indicates the tax will cost 15,000 chemical industry jobs each year during the five-year period studied. More than 200,000 4/ jobs in basic industries will be lost each year; and 600,000 jobs 5/ would disappear in the overall economy.

CHEMICAL DEPENDENT INDUSTRIES

But the impact of higher chemical costs does not stop with the chemicals, fibers and plastics industries. These materials are basic industrial building blocks. Plastics, fibers and chemicals are essential materials for the automobile industry. Chemicals are used for fertilizers and pesticides by the agricultural industry and as food preservatives in the food industry. Plastics and fibers are also used as packaging in the food industry. Chemicals, plastics and fibers are used for home construction and furnishings. The list goes on and on.

A study by the consulting firm of Arthur D. Little, Inc. found that 31 percent of all U.S. manufacturing

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3/ An Investigation of the Impact of Energy Taxes on the Economy, Data Resources, Inc., June 24, 1985.

4/ Id.

5/ Id.

industries are significantly dependent on the use of petrochemical products. 6/ As prices for these products are forced up by oil taxes, the production costs of all of these downstream U.S. manufacturing industries will be forced up as well. In time the downstream industries may buy their chemicals, fibers and plastics offshore. But buying supplies abroad can increase costs and decrease reliability of supply. If U.S. manufacturing industries are forced to purchase their chemical materials from abroad, in time we fear they will move their plants and jobs abroad, too.

Some have urged a tax on imported oil as a national security measure. But we urge you to consider the adverse impact on national security if our basic petrochemical, plastics and fibers industries are forced overseas. Petrochemical-based synthetic and plastics materials are used in aircraft, rockets, military vehicles and weapons. Many of these materials must be produced according to very high quality specifications for sensitive military applications. The danger of losing these basic industries as a result of taxing petrochemical feedstocks should be seriously considered by any who favor an import tax as a contribution to the nation's security.

6/ 1983 Petrochemical Industry Profile, prepared by Arthur D. Little, Inc. for the Petrochemical Energy Group, September 1, 1984.

THE STRUGGLE TO STAY COMPETITIVE IN WORLD MARKETS

The chemicals, fibers and plastics markets are world markets. U.S. products containing petrochemicals, including textiles, automobiles, fertilizers and pesticides, tires, plastics, pharmaceuticals, and paint and coatings are already under severe competitive pressure in domestic and foreign markets, as the attached tables show. For example, between 1982 and 1984, imports of finished plastics products *doubled*. Imports of plastics resins during the same period *tripled*. 7/ During the five years ending in 1984, chemical imports grew 11 percent a year. 8/ An energy tax will further erode our competitive position. It makes no sense to do with energy taxation what we seek to prevent in our trade policy.

The U.S. chemical industry, including plastics, resins and man-made fibers, is the only major process industry that exports more than it imports. In 1985 the chemical industry employed more than one million people, invested $17 billion in new plants, and provided a positive foreign trade balance of $7.6 billion. 9/ The industries that consume petrochemicals are also vital to the U.S. trade

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7/ U.S. Imports, Consumption and SIC-Based Products by World Areas, FT210/Annual 1982 and 1984, U.S. Department of Commerce, Bureau of the Census.

8/ *CMA News*, February 1986, p.4.

9/ *Id*.

balance. Arthur D. Little, Inc. estimates that 36 percent of U.S. exports are petrochemical-dependent products. 10/ We are fighting to keep our industries competitive. We ask you not to subsidize our foreign competitors by imposing a tax on our raw materials.

Suggestions have been made that some form of basic petrochemical tariff or rebate would eliminate the negative impact on our industry of an oil tax. In our judgment, this would be not only complex but ineffective. Protection at the petrochemical level, for example, would simply drive the problem of increased imports downstream to tires, plastic products, or other finished products.

RETURN TO GOVERNMENT CONTROLS

Our industries applauded President Reagan's decision in 1981 to end government controls on oil prices. And we have supported the President's call for total deregulation of natural gas as well. Other deregulation initiatives have brought competition to energy markets that have benefitted both individual and industrial consumers.

I vividly recall the 1960s when an oil import quota was in place. Year by year the government staff managing the programs grew larger, and the pages of federal regulations became more numerous and complex. If the past

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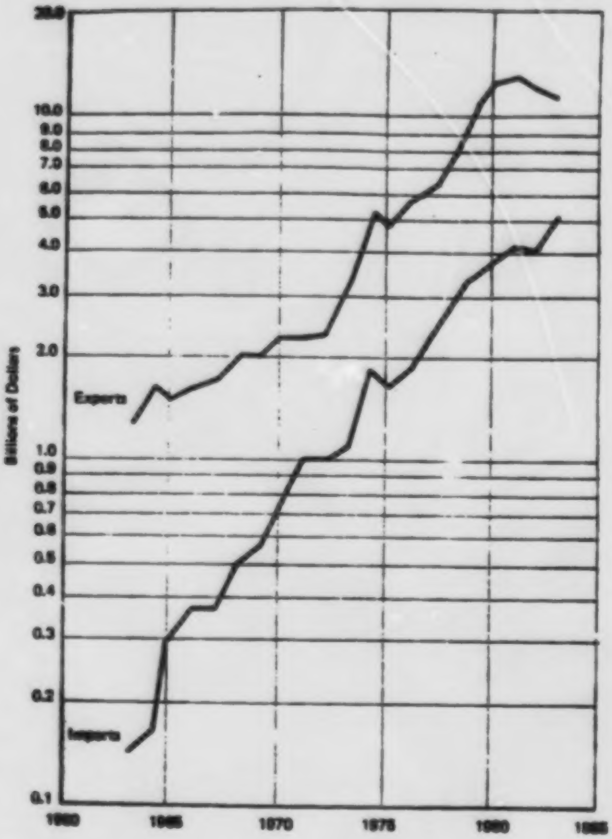
10/ Trade Trends in Petrochemicals: 1983, A Report to the Petrochemical Energy Group by Arthur D. Little, Inc., August 1984.

is any guide to the future, an import tax will mark a reversal of deregulation and a return to massive government intervention in U.S. energy markets. Exceptions will favor certain industries and certain regions. Our industries' ability to compete will be more a function of our skill in Washington lobbying than our ability to produce products at competitive prices. If there were no other reason for our industries to oppose an oil tax, this would be reason enough.

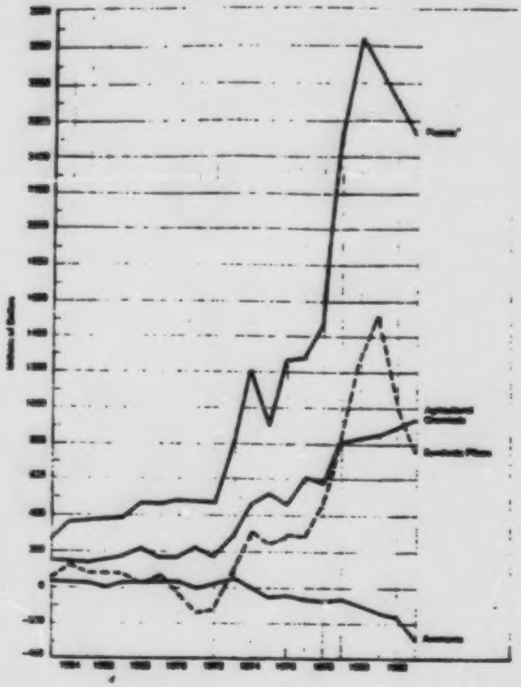
Surely, rendering our manufacturing industries uncompetitive and returning to massive federal intervention in U.S. energy markets would not auger well for either national security or meaningful federal budget deficit reduction. We are convinced that an oil tax will create far more serious problems than it will solve, and we urge you to oppose any such initiatives.

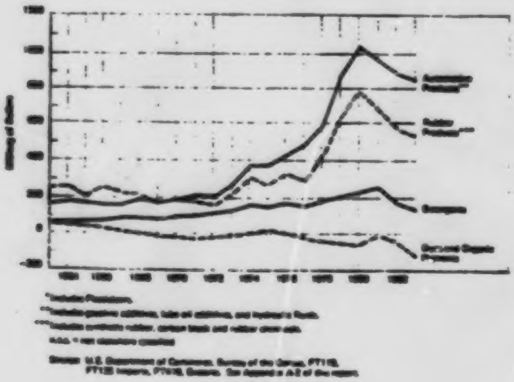
U.S. IMPORTS AND EXPORTS OF PETROCHEMICALS



Source: U.S. Department of Commerce, Bureau of the Census,
FT110 plus FT135 U.S. Imports, FT410 U.S. Exports.
See Appendix A-1 of this report.

U.S. PETROCHEMICAL TRADE BALANCE BY PRODUCT CATEGORY





*Includes [illegible].

**Includes gasoline additives, lube oil additives, and hydraulic fluids.

***Includes synthetic rubber, carbon black and rubber processing chemicals.

n.e.c. = not elsewhere classified

Source: U.S. Department of Commerce, Bureau of the Census, FT110, FT135 Imports, FT410, Exports. See Appendix A-2 of this report.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN TRUCKING ASSOCIATIONS, INC.; ON BEHALF OF THE DIRECT TRANSPORTATION USERS, WASHINGTON, DC

Mr. DONOHUE. Thank you, Mr. Chairman. I am Tom Donohue, president and chief executive officer of the American Trucking Association. I very much appreciate the opportunity to testify before your committee today. My statement has been endorsed by the following associations representing motorists, bus owners, and airlines: The Air Transport Association of America, The American Automobile Association, The American Bus Association, The Regional Airline Associations, and The United Bus Owners of America.

Not every transportation segment has the same view on fuel taxes, but we are united in opposing an oil import fee. We believe the Federal deficit must be reduced, but an oil import fee is not the appropriate mechanism to do so. We oppose such a fee because it discriminates against transportation compared with other sectors of the economy. Fuel costs represent between 5 and 25 percent of the operating costs of transportation companies. Fuel is an essential raw material in transportation, and the companies in this sector use fuel more and more as they grow.

The transportation sector represents approximately 20 percent of the GNP but consumes 62 percent of all the oil used in this country. Unlike other industries, motorists and transportation companies cannot shift to nonpetroleum fuels, nor can we move production overseas like manufacturers are often forced to do. Today, many companies in the trucking, bus, and airline industries are operating on extremely narrow profit margins, if there are any profits at all. They have not yet come to see the benefit from falling fuel costs, which has declined far less than crude oil prices themselves. For instance, the CPI for gasoline released this week is only 11 percent below the 1981 peak, even though crude oil prices are down 50 percent from 1981 levels. In any case, fuel savings have generally been eaten up by the recent 300 to 500 percent increase in insurance premiums.

From 1973 to 1981, the transportation companies and motorists had to cope with rising fuel prices resulting from forces external to our Government, which have just been discussed. They responded by making enormous investments in more fuel efficient vehicles and aircraft and by suffering heavy losses in the process. Now, an oil import fee threatens to rob them of a chance to achieve more normal rates of return and recoup these significant investments.

Many other industries would be harmed by an oil import fee as well. These include the manufacturers of petroleum based products, who have just testified, as well as those who see oil as absolutely essential in other factors of their process. Farmers would be significantly hurt, and other users of the product would be here to talk to you on many occasions. The overall economic effect of an oil import fee would be traumatic in our judgment. One recent report estimates that a $10 fee would cost the economy from 300 to 400,000 jobs and 1 percent less growth in the GNP in the first year. It would increase fuel prices by 24 cents a gallon and raise the consumer price index by roughly 1.3 percent. A $10 fee would cost the [illegible] $3 billion, and what it would do to the regulated trucking industry is eat up the total profit from our most productive year in the last six, 1984.

The price level would probably rise more as transportation companies and producers of other goods and services dependent on petroleum attempt to pass on the higher costs to the consumers. I have emphasized the very substantial negative effect of an oil import fee on transportation as a whole. I will conclude my remarks on behalf of the trucking industry in specific by warning against the obvious alternatives to an oil import fee; and that is a fuel tax.

A fuel tax would be extremely damaging to the trucking industry and to all highway users as we noted; it would be 24 cents a gallon. But a highway fuel tax would concentrate the burden even more on only one sector of the economy, transportation, and more particularly on trucking. And this would be a gross inequity, especially for our industry that pays the highest effective tax rate in the country at this time and which has seen a road and fuel tax increase between State and Federal Government of 55 percent in the last 5 years.

In summary, any form of an oil import fee or other tax on oil and refined products would discriminate arbitrarily and unjustly against transportation. These taxes would be inflationary, distortive, and complex and would provide minimal fiscal benefits. I urge you, sir, to consider dropping this proposal.

I would like to say that I would like to put our formal statement in the record and that there is a very interesting chart at the end of that statement, Senator, that has two points on it. One, it shows where we get our crude oil now and that we only get 36 percent of the OPEC; but we are still only importing 28 percent, down from 45 percent. On the other side, it shows who is using fuel in this country; and I commend both of those charts to your attention. Thank you very much for the opportunity to appear.

[The prepared written statement of Mr. Donohue follows:]

BEFORE THE
UNITED STATES SENATE
SUBCOMMITTEE ON ENERGY
AND AGRICULTURAL TAXATION
OF THE COMMITTEE ON FINANCE

Statement of the
AMERICAN TRUCKING ASSOCIATIONS

HEARING ON
OIL IMPORT FEES

Thomas J. Donohue
President and Chief Executive Officer

My name is Thomas J. Donohue; I am President and Chief Executive Officer of the American Trucking Associations, the national federation representing all sizes and types of motor carriers.

My statement today has been endorsed as well by the following associations representing motorists, bus owners, and airlines:

Air Transport Association of America
American Automobile Association
American Bus Association
Regional Airline Association
United Bus Owners of America

Not every transportation segment has an identical view on fuel taxes, but these groups are united with us in opposing an oil import fee. Some of them may submit their own statements for the record as well.

SUMMARY

We strongly oppose imposition of an oil import fee as proposed by S. 1507 and S. 1997. These taxes would be extremely inequitable in their effects on different regions, on transportation relative to other industries, and among firms within the transportation sector. A fee would raise consumer prices, since it would be reflected directly in the cost of consumer purchases of fuel and indirectly in many other goods and services. It would be an unstable and unreliable deficit reduction device. It would also be very complex once the inevitable exemptions for various producers and users were added.

INEQUITIES

An oil import fee is a tax. For autos, it is equivalent to a gas tax; for trucks and buses, a diesel tax; for aircraft, an aviation fuel tax. A $10-per-barrel import fee (as levied on refined products under S. 1507) adds roughly 24 cents to the price of each gallon of these fuels, almost as surely as a tax on all oil or an explicit tax at the pump.

The fee has many of the same defects as taxes at the pump. It discriminates against different individuals, industries, and companies within the same industry.

Individual victims. An import fee discriminates against individuals based on their location, family size, and work status. It penalizes motorists in Wyoming, for instance, who on average must drive the longest distances in the nation--more than double the distance driven by New York residents. More generally, small-town and rural residents who do not have an option of public transportation are hit harder than city dwellers. Large families, which are more likely to require larger, hence less fuel-efficient, vehicles also pay more. So do households in which the breadwinner(s) must drive to work. All of these groups have less income on average than the consumers who would escape nearly unscathed: affluent, urban households with small families and small or no cars.

From an equity standpoint, these distributional effects make an oil import fee singularly unattractive. A Congressional Budget Office study estimated that in 1981 low-income households (below $7400) spent 8.2% of income on gasoline alone, while households at the top (over $36,900) spent just 3.7%. Thus any tax that increases the price of gasoline, as an import fee would do, is highly regressive.

Industry victims. An oil fee discriminates against transportation compared with other sectors of the economy. Fuel costs consume from 5 to 25% of operating costs for transportation companies. Fuel is an essential raw material in our businesses: in general, a firm must use more fuel if it is to grow. Unlike other industries, such as utilities, motorists and transportation companies cannot shift to nonpetroleum fuels. Nor can they move production overseas, like some manufacturers.

All transport modes have achieved impressive gains in the efficiency with which their engines burn fuel, but they cannot avoid using oil. That is why the transportation share of oil use has risen steadily from 52% of all users in 1972 to over 62% today, even though unit fuel use has steadily dropped. Hence an import fee will burden transportation more than other oil-using sectors.

Besides transportation, many industries are harmed by a fee. These include recreational, travel, and lodging industries that depend on discretionary spending by consumers and are vulnerable to gasoline or airfare costs; manufacturers of petrochemicals and other petroleum-based products that compete in world markets with producers that do not face a new tax on oil; farmers and other users of those products; domestic carmakers, whose products on average use more fuel than imports; banks and other businesses that sell or lend to countries whose oil sales would drop as a result of a fee.

Victims within transportation. A fee penalizes firms differentially within the transportation sector. Because of the types of products they haul or the distances they travel, the fuel efficiency of different fleets varies. For instance, aircraft or trucks that operate over long distances are inherently more fuel-efficient than short-haul/local ones. Trucks that carry heavy loads must burn more fuel than ones that operate often with light or empty loads. The ability of firms to pass on fuel taxes to their customers varies as well, because some customers have greater market power or a wider choice of carriers or suppliers. As a result, a tax would fall very arbitrarily on different firms in the same transport mode.

ECONOMIC AND FISCAL IMPACTS

One recent report estimates that a $10-per-barrel fee would cost the economy 300,000-400,000 jobs and 1% less growth in gross national product in the first year. The losses would occur not only in the specific industries cited above, but throughout the economy as consumers' disposable income dropped and as efficiency declined due to the price distortions of more costly oil products.

An oil import fee is bound to push producer and consumer prices higher than they would otherwise be. This is true whether the tax is imposed when crude oil prices are falling, stable or rising. In each case a fee of $10 per barrel is likely to push up fuel prices by 24 cents per gallon. With motor fuel representing 5.5% of the CPI, such a hike means an immediate jump in the CPI of roughly 1.3%. The price level is likely to rise more as transportation companies, producers of other goods and services with a significant petroleum cost, and of fuels that compete with petroleum, pass on their higher costs to the extent market conditions permit.

These increases are one-time changes. But they trigger cost-of-living adjustments (COLAs) in wage contracts that can ignite a second round of price increases for some products. The tax would also force a larger COLA for social security and many other federal programs. The fiscal dividend would be pared still further by falling income tax collections from transportation and other companies that pay higher fuel costs and cannot pass the costs along. Meanwhile, with no offsetting increase in personal income, a jump in the CPI lowers personal income tax receipts by raising the floor on each bracket and personal exemption. Finally, conservation by motorists lowers highway fuel tax receipts. Thus, the fiscal benefit from an import fee is undermined and perhaps totally offset by declines in other revenues and by higher outlays.

The fiscal impacts can be summarized as follows:

DEFICIT EFFECTS OF OIL IMPORT FEE

Revenue effects	Improves (+) or Worsens(-) Deficit
Direct revenue from fee	+
Windfall profits tax (due to higher domestic crude prices)	+
Individual income tax (due to indexing, GNP & job loss)	-
Social security tax (due to job loss)	-
Corporate income tax (oil industry +, all others -)	-
Existing fuel excise taxes (due to conservation)	-
Outlay effects	
Social security, other entitlements (due to higher CPI)	-
Unemployment, welfare benefits (due to job loss)	-
Net effect	?

EFFECTS ON TRANSPORTATION BUSINESSES

Today, many companies in the trucking, bus, and airline businesses are operating on extremely narrow margins. They have yet to see much benefit from falling fuel costs, which have declined far less than crude oil prices. For instance, the CPI for gasoline released this week is only 11% below its 1981 peak, even though crude oil prices are down by 50% or more. In any case, fuel savings have generally been eaten up by skyrocketing insurance premiums or passed along to passengers and shippers. An import fee could easily leave fuel prices higher than they are now, pushing some companies out of business. The resulting unemployment would worsen the fiscal picture even more, by cutting employment and income tax receipts and adding to unemployment and welfare outlays.

A $10 fee would cost airlines $3 billion, roughly four times their 1985 profits. The same fee would cost the 2100 regulated trucking firms that reported results to the Interstate Commerce Commission in 1984 more than their total profit that year, which was their best since deregulation.

S. 1507 and S. 1997 would both theoretically remove the tax on oil once its price rose above a certain level. However, the recent history of tax legislation suggests that, once in place, the taxes would more likely be made permanent. Transportation users thus would be denied the benefits of falling prices while getting saddled with the harm of rising prices.

Transportation companies and motorists had to cope with rising fuel prices without government assistance from 1973 to 1981. They responded by making enormous investments in more fuel-efficient vehicles and aircraft--and by suffering heavy losses in many cases. Now an oil fee threatens to rob them of the chance to achieve more normal rates of return and recoup those investments.

COMPLEXITY

An oil import fee would not be enacted without exemptions.

S. 1507, for instance, exempts home heating oil and fuel used in manufacturing goods for export. Exemptions for agriculture, nonprofit institutions, and governments are frequently suggested. So are exemptions for certain producing countries, notably Mexico, our largest supplier (17% of imports in 1985). Other producing nations are also in precarious financial shape or are equally strategic allies and would doubtless be given preferential treatment. (See Charts 1 and 2 for shares of oil usage by sector and imports by country.)

A justification can be offered for each of these exemptions. Yet each one adds to the complexity and the distortions inherent in an oil import fee. Each one also narrows the tax base, leaving transportation carrying more of the burden.

CONCLUSION

I have emphasized the very substantial negatives of an oil import fee for transportation as a whole. Let me close on behalf of my industry, trucking, by warning against the obvious alternative to an oil import fee: a gas tax. (The trucking industry's objections to a gas tax are shared by AAA and bus owners.)

A gas tax, whether limited strictly to gasoline or applied to all highway fuels, would be extremely damaging and unfair to the trucking industry and all other highway users. As noted, a $10-per-barrel tax on imported refined products would be equivalent to a 24-cent-a-gallon tax on gas and diesel. But a highway fuel tax would concentrate the burden even more on only one form of transportation, creating a great competitive disadvantage as well as an absolute cost increase for trucks. It would be grossly unfair to single out one industry to pay such a large share of a tax burden. That is particularly true for trucking, which pays the highest effective federal corporate income tax rate and contributes to deficit reduction through payments to the Highway Trust Fund. (The Fund currently has a $13 billion balance, which is helping to reduce the deficit.)

In summary, any form of oil import fee or other tax on oil and refined products would discriminate arbitrarily and unjustly against a variety of individuals and businesses, particularly in transportation. These taxes would be inflationary, distortive, and complex, and would provide minimal fiscal benefits at best. I urge you to drop any such proposals from further consideration.

Petroleum Consumption by End-User - 1984

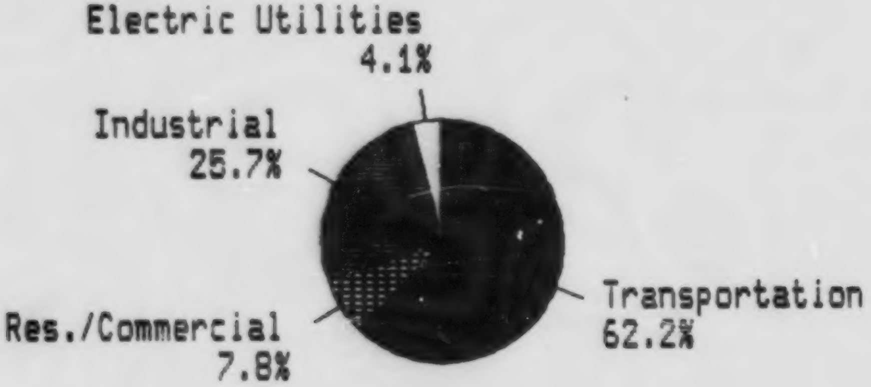
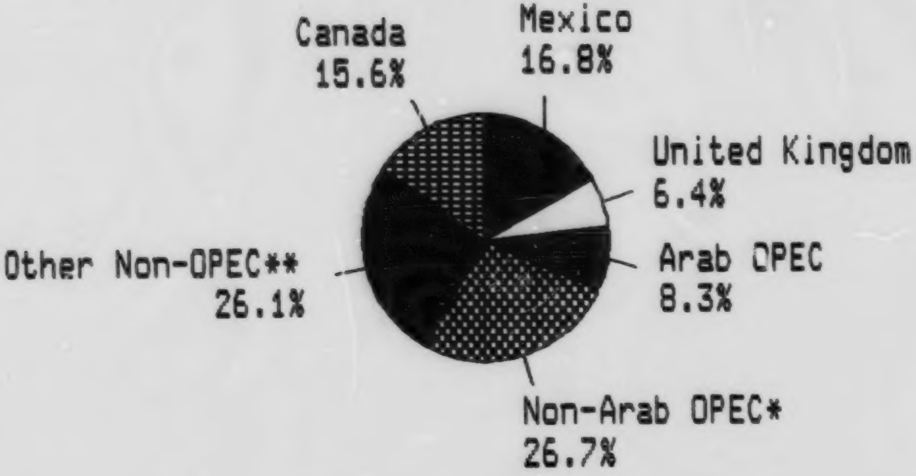


CHART I

Source: U.S. Department of Energy

1985 - Crude Oil and Petroleum Product Imports (By Country)



Source: U.S. Department of Energy

* Includes Indonesia, Iran, Nigeria, Venezuela, Ecuador and Gabon

** Includes Bahamas, Netherlands Antilles, Trinidad and Tobago, Puerto Rico and Virgin Islands

CHART II

Senator Wallop. Tom, I would think that chart is as of 1983. Is that correct?

Mr. Donohue. It is 1984, I believe.

Senator Wallop. 1984?

Mr. Donohue. Yes.

Senator Wallop. Our indication is that we are back up 32 percent.

Mr. Donohue. That is correct.

Senator Wallop. As of last year. So, the trend is in the opposite direction. It perhaps sounded like quibbling when we were at 45, but I think that one of the reasons that we got to 45 and had the troubles that we got into is that we didn't anticipate trends, and also at numerous other times in our history. Senator Matsunaga, do you have any questions?

Senator Matsunaga. Yes, Mr. Chairman. First of all, I want to commend the panel for excellent testimonies presented. I am sure that your testimonies will help tremendously in our deliberations.

A number of prominent economists have asserted that an oil import fee would reverse some or all of the economic growth and lower inflation generated by the decline in crude petroleum prices. Of course, some of you have dwelled on this, but Dr. Brossard, what would be your assessment?

Dr. Brossard. I should say I am not an economist. However, I have been studying it for most of my life.

Senator Matsunaga. Well, maybe your views will be sounder. [Laughter]

Dr. Brossard. I should state that I truly do believe in the free market, even when it hurts. I think that, if I might in answering that question, just refer to a question that Senator Wallop asked twice previously of other members. It might answer the question. He asked if the price of oil outside of the United States would decrease if we did impose an oil import fee. I would use the historical data on that and go back to the Mandatory Oil Import Program of 1959 when we kept cheap OPEC oil out of this country, which was selling at $1.80 a barrel and we paid $2.80 a barrel, for domestic, more or less, for about 10 years while Europe and Japan benefited enormously and rebuilt on the basis of all that cheap OPEC oil. So, I do believe that if we do impose such a fee, it will continue to depress the oil market outside of the United States because we are the largest market, and the fee will benefit other consuming countries. We will not benefit from that cheaper oil. Therefore, our economy will not benefit either because our exports will not grow. Our manufacturing industries will not be able to compete, and certainly we have two very important areas here that have been more or less addressed previously but I should emphasize because I do come from the State of Louisiana, and that is the petrochemical industry and agriculture. Those two are our largest exporting industries, and they would be hurt by an oil import fee.

Senator Matsunaga. Mr. Donohue, you already touched on this, but would you care to expand on it?

Mr. Donohue. Just a little bit, Senator. I would concur that the great beneficiaries of an oil import fee would include amongst them those countries that received new investments and factories as we moved manufacturing offshore, and the Japanese economy which would benefit from a price that is driving down on the international market while maintaining the protection they have from treaties with the United States that, should they ever find themselves without oil from the OPEC nations, that we would rush to their aid. It seems to me that when you look at motor fuel amounting to 5.5 percent of the CPI, and look at what a $10 tax would do in terms of an increase in the CPI and then moving that on to COLA increases and the reduction of income tax paid and so on, that we really have to put a model together of what happens after you pull the lever with an import fee. And I am not an economist either, but I have a sense that there are more numbers of this equation than just the $10. I would be concerned for our economy.

Senator **MATSUNAGA**. Mr. Wishart, do you wish to add anything?

Mr. **WISHART**. Yes. I think the particular case of the petrochemical industry and the downstream industries which depend on it emphasize the points that the earlier speakers have made and the point that you have brought up, Senator.

Of the process industries, only the petrochemical industry has a positive balance of trade. At this present time, it is $7 billion; but it is declining rapidly. It was $15 billion just 3 or 4 years ago. That trend would be exacerbated obviously by the very significant adverse impact of this oil import fee. I pointed out that in the gross terms, $5 on $15 is 33 percent, but we are talking in at least one of the bills about a $10 margin. If the price of oil is $15 and we have an environmental fee of $10, that is a 66 percent adverse impact. It would be very tough to live with.

Senator **MATSUNAGA**. Mr. Wallace, in your prepared statement, you cited an old Oriental proverb: Fool me once, shame on you; fool me twice, shame on me. Did you, by quoting that, mean to tell us that there is a planned program of fooling us in the dropping of Middle East oil at this time?

Mr. **WALLACE**. Without any question.

Senator **MATSUNAGA**. Without any question?

Mr. **WALLACE**. Without any question, the Saudis are following a stated pattern and the intention that they have. They realized when our consumption and production graphs crossed in 1983, they understood with their reserve and our decline in reserves, Senator, that they had the ability to do it. That is what I describe as an Arab yo-yo. They yo-yoed that way then, and they are yo-yoing this way now. And they intended to do it, and they are using 1987 as the date because they are looking at our production numbers just like we look at them.

Senator **MATSUNAGA**. Would not the answer be to develop our alternative sources of energy to the point that we won't need to depend upon the foreign imports of oil?

Mr. **WALLACE**. Yes, sir, but you can't develop coal. You can't develop shale. You can't develop solar. You can't develop biomass, if they are giving crude oil away until they kill all those incentives.

Senator **MATSUNAGA**. As you know, we do have tax incentives for the development of alternative energy; and, in fact, at least in my home State of Hawaii, such incentives have proved very successful. And I do intend in a genuine way, if I may use the term, to pursue such tax incentives.

Mr. **WALLACE**. And you would be commended for it, Senator.

Senator **Matsunaga**. Pardon me?

Mr. **Wallace**. You would be commended for that.

Senator **Matsunaga**. I thank you. I very seldom get commended, so I will accept that. [Laughter.]

Mr. **Wallace**. I don't either, and that is why I am quick to commend folks who are on the right track.

Senator **Matsunaga**. Yes. You had your hand up?

Dr. **Brossard**. Yes. I would like to make a comment. All morning, I have not heard something that I think should be mentioned in regard to the drop in the price of oil. The Saudis are being blamed for it solely. The Saudis have certainly tried to get back into the market with their netback deals; and with these netback deals, they have tried to raise up to at least their quota—up to their quota of 4.3 million barrels within OPEC. I beg to differ with some of the former testimony. I don't believe that their intention is to drop the price of oil to a price that would hurt them as well.

What has been driving the market is the futures market, and it is the futures market that has not been mentioned at all here this morning. The Saudis are being hurt just as much by the futures market as the price drops, except for the fact that they now have netback deals.

What is occurring is a total restructuring of the oil industry. And we have something that is very new that is a very strong influence, and that is the MERC. The New York Mercantile Exchange is a very powerful force today. The international oil companies, the majors, used to set the price of oil before OPEC started to set it in the 1970s. Since 1983 we have crude oil sold on the MERC, and since last year when more options were taken and there was more activity on the MERC, the MERC has started to control the price. The price right now is being led by the futures market.

Senator **Matsunaga**. Are you suggesting we outlaw the futures market?

Dr. **Brossard**. No, I am not. I am not at all. I think that this is simply a new form of price setting, and it is a paper barrel that we are talking about, not a wet barrel, but it has a very strong influence on the spot market, which is of course now the dominant market. We are no longer on long-term contracts. We are more than 50 percent, 70 percent, no one really knows how much is now in the spot market—but the futures market is leading the spot market, which is now dominant in the oil industry.

Senator **Wallop**. Dr. Brossard, I know that you have had and do have and that you stated your relationship with the Venezuelan oil industry, and that they are a cooperating part of OPEC, but the Mercantile Exchange of which you just spoke this morning just opened West Texas intermediate crude at $12.70.

Dr. **Brossard**. Wow.

Senator **Wallop**. And I would again tell you, when you say that Yamani and the Saudis are not controlling the market, that it was Yamani who had the press conference this morning in which he said that the price would continue to fall to $10. So, he thinks he is controlling it. He may not be; but if he is confident enough to hold a press conference and say where the price is going to go, he certainly thinks that he has an influence on it.

Dr. **Brossard**. I do not mean to discount the influence of the Saudis one bit because the Saudis definitely do have the largest reserves in the world of conventional oil. They, with 500 wells, can produce 5 million barrels. In other words, they have wells that their average production is 10,000 barrels per well, whereas this country has 620,000 wells—producing wells—and we have an average of only 15 barrels per well. We are high cost producers; they are very low-cost producers. And as a result of that, obviously, they have an enormous influence on the market. I am not discounting that influence. I am just saying that it isn't the only influence. That was my only point.

Senator **Wallop**. Indeed. I think the previous witnesses testified about sweating the market. Standard Oil used to be the only producer in this country, but they were big enough to sweat the market, and in effect, work their will on it over a period of time.

Dr. **Brossard**. The Saudis had very good teachers.

Senator **Wallop**. Indeed they did. Senator Bentsen?

Senator **Bentsen**. Thank you very much, Mr. Chairman.

I was just listening to that price you quoted, thinking what it means to production in this country and what it means to drilling. I was looking at Commissioner Wallace's testimony, saying that wildcat drilling, exploration is off 28 percent this year. That is just the beginning of the decline.

Mr. **Wallace**. Just the beginning, Senator.

Senator **Bentsen**. You listen to a low price like that, what would you forecast is going to happen? How many rigs do you think are going to be operating?

Mr. **Wallace**. Senator, it is falling so quickly that we can't work the numbers. If it stays at $15 barrels——

Senator **Bentsen**. I will bet you the banks can work the numbers, and they are not going to be financing any drilling at these prices.

Mr. **Wallace**. We did some work on $15 a barrel for six months, and you lose 30 percent of your production in your country. I will tell you that the rig count will drop to 50 percent or below, if any. At $12 a barrel——

Senator **Bentsen**. If any?

Mr. **Wallace**. If any.

Senator **Bentsen**. That is right. And it is just amazing how quickly we forget in this country what happened to us, you know. We got our imports down to 31 percent, and we did it by bringing in new sources, being able to keep our stripper wells going.

Mr. **Wallace**. Yes, sir.

Senator **Bentsen**. We started doing some things with steam injection, with carbon dioxide—and other quite expensive techniques—to try to hold those reserves up, to maintain those reservoirs and to bring more production out of what we would have lost otherwise. I look at California heavy crude. And, I look at the prices of production in Alaska. They stop production if we let the prices drop to this. Now, does anyone really think that the Saudi Oil Minister Yamani is doing this because he wants to keep down the price?

Mr. **Wallace**. No, sir.

Senator **Bentsen**. No, he doesn't. He wants to whip non-OPEC production into line, doesn't he?

Mr. **Wallace**. Yes, sir.

Senator **Bentsen**. And once he has them locked in, then you are going to see that prices will skyrocket.

Mr. **Wallace**. Yes, sir. They will reintroduce you to the price of Saudi oil.

Senator **Bentsen**. That is right.

Mr. **Wallace**. It is like a heroin dealer giving away dope.

Senator **Bentsen**. We are going to get hooked again.

Mr. **Wallace**. All you have to do is give it away for a week.

Senator **Bentsen**. And you watch the price go back up. Soon, we will be importing 50 percent of our oil. What do you think it does to the defense of this country—the vulnerability of it? Our short memories is a frustrating thing. I really want to look at my testimony and testimony from other people 12 months and 24 months from now, and see who was the better forecaster.

Mr. **Wallace**. That is the ironic thing, Senator. I thought there was a sense of deja vous here today because I remember some of my appearances here in 1974.

Senator **Bentsen**. Yes.

Mr. **Wallace**. And I look around and the faces have changed, but the issue is the same; and we still don't have an energy policy.

Senator **Bentsen**. That is right.

Mr. **Donohue**. Senator, if I might just make one comment?

Senator **Bentsen**. Yes.

Mr. **Donohue**. I think you certainly have a very dramatic situation with the announcements of those on the exchange and Mr. Yamani's this morning; and those are matters that require energy policy determinations by the Congress and the administration. I would hope, however, as we begin to develop that policy, we don't see an oil import fee as the only tool in that policy. As indicated by Sheik Yamani this morning he is willing to go a lot lower than we are willing to go higher; and we need to find some other means of dealing with this matter, or we are going to find ourselves in a bidding war that is going to seriously affect our domestic industries, help our competitors in the manufacturing process and leave us, I am afraid, at a significant disadvantage.

Senator **Bentsen**. Mr. Donohue, I just hope you still have something to haul in Texas. That is my concern. Every dollar that that price goes down costs us 25,000 jobs in Texas. If it goes down $10, that is a quarter of a million jobs. More over, the Gulf Coast of Texas, is already in a deep, deep recession.

Mr. **Donohue**. Yes, sir.

Senator **Bentsen**. And that is what concerns me. I listened to some of the comments yesterday about our lack of our energy policy being a regional thing. Yes, I guess it is; but when one region of the country gets in trouble, the whole country gets hurt by it. It spills over. I can't help but remember when we had a problem with a place called New York City, and they began to ask for some of the fellows from the Sun Belt to help tide them over and give them a breather, give them a little stability; and some of us walked right up and did it. It wasn't very politically popular at that moment in our areas. And that is what we are talking about now. I can see in the short run an economic benefit to most of the Nation from lower prices; but in the long run, when we get hooked again on foreign oil, I see a great vulnerability in the defenses of this country.

And then, I also know what is going to happen to that price, once they reestablish a cartel where they can lock in a higher price.

Mr. Donohue. Senator, I would not argue with that. I just would like to associate myself with your concern about what we have to haul. Today in the United States, we are hauling the same bulk, volume, and weight of materials as we hauled in 1978 and 1979 because of the massive amount of manufacturing and jobs that have moved out of this country.

Senator Bentsen. Absolutely.

Dr. Brossard. And if I might comment, too, Senator Bentsen, I am from the State of Louisiana and all Louisianans are not hurt right now. Our oil producers certainly are hurting, but our petrochemical industry will be helped. Our farmers will be helped. And interestingly enough, LOOP is being helped right now because, of course, with the netback deals with Saudi Arabia, more Saudi oil is once more coming into the United States. So, there is always pain and there are always benefits.

Senator Bentsen. I understand Louisiana, and I understand Texas; and I know a lot of people in Texas and Louisiana who don't think they are in the oil business.

Dr. Brossard. That is true.

Senator Bentsen. But they sure are, because it spills over on each and every one of them. Thank you.

Senator Wallop. Mr. Wishart, did you want to comment?

Mr. Wishart. Dr. Brossard made one of the observations I wanted to make. Senator Bentsen, you know we in the petrochemical business are heavily invested in Texas, and that is the other aspect of this situation. It is certainly true, I think, that petrochemicals are fundamental to the economic viability of this country. And I am repeating again that the national security is very much a function of the industrial strength of the nation.

So, as a user versus a producer of petroleum, the tension is created which you are very aware of and you have made very constructive contributions to in the past.

Senator Bentsen. Thank you.

Senator Wallop. The problem that I see emerging here started maybe, in some respects, with your testimony, Dr. Brossard, and went down the table. One of your theses in a very interesting paper with interesting historical conclusions in it was that we are in a declining state of reserves and have been for some time, anyway and that we ought to seek to maintain and indeed improve our relations with those countries which produce it. And I look at those countries which produce it, and we see Canada, Great Britain, and Norway as the only ones who have stable means of exchanging governments.

Dr. Brossard. I beg your pardon. Venezuela has had a constitionally elected president since 1958.

Senator Wallop. And Venezuela is very close to Nicaragua today.

Dr. Brossard. It is? I thought it was on the South American continent.

Senator Wallop. Well, my friend, if you believe that the events in Nicaragua will have no effect on politics in the Caribbean, in the Atlantic side of the South American continent, and in this hemisphere, I would wish you are right; but I suggest to you that you are not.

Dr. Brossard. Excuse me, Senator, but Fidel Castro was very interested in Venezuela right after he took power.

Senator Wallop. Yes, and——

Dr. Brossard. I happened to be living in Venezuela at that time. I was married and raising my children; and we had all kinds of terrorism and guerrilla activity——

Senator Wallop. You feel no threat at all by the new events?

Dr. Brossard. Oh, of course, I do. Absolutely.

Senator Wallop. That is what I am suggesting.

Dr. Brossard. Oh, no. I do.

Senator Wallop. Mexico has had a constitutional government for a substantial period of time, too, but I am suggesting to you that if I was betting on them to come, I would bet more on Canada, Great Britain, and Norway to remain stable in that stable of producers.

Dr. Brossard. But, Senator, you mustn't forget that the oil industry was developed down there by Americans. One of them was my father.

Senator Wallop. I don't forget it at all.

Dr. Brossard. And those men who are now running the industry, the ones that were trained by them, have a professionalism and a closeness to this country that is pragmatic.

Senator Wallop. I know how they are and how they feel. It is the question of whether it will be up to them to say what is done. It was the case in Libya, too, was it not that we devised it, designed it, engineered it, produced it, and structured it? And now——

Dr. Brossard. But they had a very corrupt King Idris.

Senator Wallop. You are quite right, but I am just suggesting that the threat of political instability in this hemisphere is not to be discounted as we look to the future and the strategic problems that are here. As Mack Wallace suggested, 70 percent of the world's oil is produced by governments, not by companies; and it is I think probably fair to say that those governments are perhaps more efficient in their structure of energy policy than are we who have 27 committees of Congress and 45 departments and agencies of Government. Probably the one with the least say in energy policy is the Department of Energy. [Laughter.]

Senator Wallop. And I worry because I have been sitting here, along with Senator Bentsen and others, trying to figure out how to make some sense out of energy policy. And all I see as I said to Senator Heinz in the morning is that Congress gets an irrational sense of rage when the prices go up and a complete sense of forgetfulness when they go down. We simply cannot come to grips with that as a part of a national policy. Sparky suggests that we ought to go to alternatives, but alternatives, as was witnessed here both yesterday and today, are entirely dependent on their economic viability for the price of oil.

Dr. Brossard. I attended a conference on Monday, Senator, if I might just mention it, about Canada, an all-day conference held by the Center for Strategic and International Studies and put together by Henry Schuler who testified yesterday. One of the things that came across very strongly there was the importance now of heavy oil development. And if there is an oil import fee imposed and Canada is not excluded from that oil import fee, it is going to shut down their major development, which is their heavy oil, because they only utilize 15 percent of it and——

Senator Wallop. I do feel very strongly about our relations with our neighbor to the north, but our heavy oil is gone.

Dr. Brossard. Gone?

Senator Wallop. Yes. Gone.

Dr. Brossard. I think we still have quite a bit in Texas.

Senator Wallop. Oh, yes, you have it, but do you think it is going to be produced with a $10 a barrel price?

Dr. Brossard. Well, we haven't made much of an attempt at producing it prior to this, except in California.

Senator Wallop. Look, that industry in California, Utah, Wyoming, and Texas is dead at $10, and I assume that it may well be just as dead in Canada at $10; but they have some because the government——

Dr. Brossard. Excuse me. I was talking not about our heavy oil, the comparison, but their 10 degree API gravity, and their oil——

Senator Wallop. I know, and I feel very badly for them; but goodness sakes, I feel badly first inside our own borders where it is gone first. That is what I am saying. There comes a time—and look at Mr. Wishart's testimony which is absolutely fascinating and very valid—so long as there is a peacetime world economy, and only so long as there is a peacetime world economy, it is not possible for me to contemplate what your industry would do if there was a hostile interdiction on oil and gas supplies. You will recall, along with the farmers and others, as we tried to figure out how we were going to break up the shares in the strategic reserves; and we are not going to be able to come back quickly with a vanished oil and gas industry to supply you with petro bases to make anything, if it is gone.

So, it is entirely dependent on peace; and I maintain that we have an obligation at least to examine the strategic problems that are being created by the present shortage and the decline in the U.S. ability to maintain some basic level of production capacity in the energy industry.

Mr. Wishart. May I respond to that briefly?

Senator Wallop. By all means.

Mr. Wishart. Senator, your concern for the national security is a primary concern of government. I would suggest that it has many dimensions, and I have tried to emphasize the strength of the industrial sinews of the country as well as its fuel sources. With respect to the fuel sources, things are very different today than they were in the mid 1970s, that is there is much more non-OPEC production and much more conservation, a subject that I know you have devoted yourself to, as I have. And we have been very successful. The most effective change or impact on the utilization of oil has been the reduction of the use by more efficient use in the

United States and elsewhere. That is good; but the other kinds of things are that we are down to 7 percent Arab OPEC oil in our import mix. Yes, the Congress of the United States, I think, should address policy questions relating to its national security. I think reacting to a short-term change in the market that is essentially self-correcting may be a mistake.

If we look back at the 1970's——

Senator Wallop. If it is a short-term change——

Mr. Wishart. I think we can argue that the suppression of prices in the United States extended the duration of the impact of that increase and maybe even enhanced it. I think that is a pretty good argument today.

Senator Wallop. I think that is fair.

Mr. Wishart. And if we look at $10 oil, that will be rapidly corrected. In Europe, there will be a rapid switch from coal to oil, doubling the demand in the utility industry. There is a stabilizing effect in these prices, which will occur if it goes unhindered. We don't like to go through the process, but in the end, the market forces are the only forces which will control it.

Now, if you are looking at the broader policy implications, we must—we must—and this is another kind of question all together—for a lot of reasons, not just oil, have stable, friendly governments on our southern and northern borders. And I think Mr. Reagan and the rest of your party is very concerned and working on that—a most important question.

Senator Bentsen. I wouldn't say that is monopolized by the Republicans. [Laughter.]

Mr. Wishart. Yes, that is right. That is bipartisan.

Senator Matsunaga. If I may ask one question of Mr. Wallace?

Senator Wallop. Yes.

Senator Matsunaga. Mr. Wallace, for my own edification and education, a statement was made here that if the oil price dropped to $10, the oil industry would be out. As I recall in 1973, the price of a barrel of oil was $2.40. The American oil industry was doing very well at that time. Now, $10 would be 400 percent of that; and yet, the statement being made here is that $10 would mean bankruptcy of the oil industry in America. Could you explain that for me, at least?

Mr. Wallace. Yes, sir; a tool pusher could buy a pickup for about $900.

Senator Matsunaga. What is that?

Mr. Wallace. A tool pusher, a driller, people that work on the rig could buy a pickup for about $900. It is considerably more now. Spark plugs cost a whole lot more. Steel costs a whole lot more. There has been an across the board rise in the prices.

Senator Matsunaga. So, you are saying that the inflation has risen by 400 percent since 1973?

Mr. Wallace. Well, I am not an economist, but my wife tells me it is pretty serious. I would say that it is close to it.

Senator Matsunaga. I assure you that I am as much concerned about the oil industry surviving as I am about the sugar industry surviving.

Mr. Wallace. And I am as interested in the sugar industry surviving as I am the oil industry, Senator, for this reason: We are all in a boat together in this Nation, in these States; and none of us can look at the other and say your end of the boat is sinking.

Senator Matsunaga. Right. So, we are here to find a solution, what to do.

Mr. Wallace. Yes; and I would add this one point.

Senator Matsunaga. Of course, therein lies the differences.

Mr. Wallace. The difference is this to me: There are only two kinds of imports you can bring into a nation: strategic and nonstrategic. In my judgment, fuel is strategic. If we do not maintain a fuel base, none of these other things, as Senator Bentsen pointed out, are possible.

Senator Matsunaga. Thank you very much.

Senator Wallop. I have a curious observation to make. One of the witnesses yestesday, Mr. Steuart, was testifying in opposition to an import fee and sold half of his company to the Venezuelans which permits them to circumvent the strict requirements of OPEC. It is nothing illegal; I am not suggesting that, but it is a rather interesting item that we were hearing at least from one of those who might be affected by us in more ways than just as an importer. But I want to go back, Mr. Wishart, to what I was saying, and with you, Tom. I don't quarrel that the economic tensile of this country is every bit as much a strategic requirement as the other kinds of things which we mentioned. If as you say this is self-correcting and it won't stay at $10, we can—I hope—pray that it won't go roaring back through the roof again because, Tom, I remember how very desperate you all were when it wasn't a question of price but no fuel period.

Mr. Donohue. Yes, sir.

Senator Wallop. I remember when there was a little truckers' march on Washington.

Mr. Donohue. That is right.

Senator Wallop. I was here, and I got held up by it, as I did by tractors and other things. And they are all related to fuel. And I don't think that it did this country's economy and industrial tensile strength one damned bit of good to go through that ringer. You were talking about how you now haul the same thing you were hauling in 1973; and one of the reasons it went out of this country to cheaper manufacturing areas in the world was that the price of fuel made it impossible for us to compensate for higher labor costs in this country.

So, a stabilizing effect somewhere along the line has to be considered. It may not be that the way in which Senator Bentsen and I have devised it is the way to do it, but it is clear to me that somehow or another we are going to have to find the means to maintain a surviving segment of the American industry or we will see worse than we saw in 1979. How we do that without in some way affecting price is a little beyond my comprehension. I know that Dr. Brossard you said that replacing petroleum reserves is the problem the United States should be concentrating on. I don't quarrel with that, but how do you do that in the absence of economics?

Dr. Brossard. I am sorry. I didn't understand the question.

Senator Wallop. Your statement, on page 12, says: "Replacing petroleum reserves is a problem the U.S. should be concentrating on." I don't quarrel with that, but how do you do that in the absence of an economic climate that will let you replace reserves?

Dr. BROSSARD. I believe in the free market; and I think that every time the Federal Government steps in to start to control, you referred earlier to——

Senator WALLOP. You are suggesting we step in? In your statement, you said: "The problem the U.S. should be concentrating on is how to replace petroleum reserves."

Dr. BROSSARD. Oh, yes, that is by freeing—doing away with the windfall profit tax and freeing up our industry so that they can go out and look for oil. That is what I meant by that statement.

Senator WALLOP. You won't get any quarrel from this committee on those things, but I am not certain what the windfall profit tax is going to——

Dr. BROSSARD. Oh, I know, but there are still some other——

Senator WALLOP. Yes; based on today, and it just fell through in the market this morning. [Laughter.]

Dr. BROSSARD. Yes.

Senator WALLOP. It is no longer assessed.

Dr. BROSSARD. Which was what some of us said when it was applied in 1980. If oil producers didn't raise the price of oil, the Federal Government would never get the windfall.

Senator WALLOP. Some of us were not very enthusiastic about it in those days. One of us designed its end, but it never paid in enough to get there from that direction. It has gone this way; but it will return. Senator Matsunaga's ideas about tax incentives—you know, this country has not got money enough to make tax incentives work for our renewable fuels, for our conservation efforts and other things, in the light of a $10 a barrel oil price.

Somewhere alone there we are going to come to grips with the idea that the price of petroleum is. The dollar currency of the BTU business, as Professor Yergin, or the gold standard as I have referred to it, the economic viability of all those other things plays off of and will for at least the rest of this century——

Dr. BROSSARD. Senator, if I might just add, part of the problem in the oil industry is of course the fact that there is so little long-term planning right now because they don't know what you are going to do. If there was some assurance that there could be, the large investments that have to be made in finding oil would be made, if they were assured that the Government wasn't going to step in. And if they did find oil after they had risked a great deal of investment, and the rewards would not be taken away from them by another windfall profit tax or an alternative, then the oil companies could make the investments. They have to look for the big giants now. We are a country of strippers—440,000 stripper wells compared to 200,000 wells in other countries that produce the other 44 million barrels of oil a day. They have to find the giants. Prudhoe Bay, as I said in my statement, is going to peak next year; and after Prudhole Bay peaks, what are we going to do? We have to look for the giants, and the Congress in its wisdom has set moratoriums on offshore drilling. And now, Secretary Hodell has come out with a new leasing plan that doesn't look too promising. That is what I am talking about. You have to free up the U.S. oilman so that he can go out and find oil that we need; and if Government continually interferes, it will be very difficult for us to do that.

Senator WALLOP. I don't think you will get any quarrel from the present company at the table. Lloyd, you weren't here, but the Consimers Federation of America has made the announcement that there is something really to celebrate about this loss of jobs in Texas, among other things, because for every job we lose in the oil patch, we create six in the American economy. So, you and I had better just belly up and see if we can't reestablish full employment with the policies that are underway, and let them find their energy where they will.

Senator BENTSEN. There is no question but that the oil-producing States are taking a very substantial hit on their economies. Some of the highest unemployment areas in the United States are along that gulf coast now. You can go up to Port Arthur, Orange County, Beaumont and go down to Corpus Christi and Houston. We haven't seen that kind of an unemployment rate since the Depression. It is simply critically important that we find some way to try to stabilize. Otherwise, I think exploration is gone for the foreseeable future.

In the long run, our national security is threatened if we become too dependent on foreign oil. Some statements were made about our reduced dependence percentagewise on OPEC. That dependence would increase. But it is not enough just to talk about OPEC. We have some other nations, major producers of oil like Mexico that are not a part of OPEC, that are in a very unstable position today. We have to understand that.

Senator WALLOP. I want to thank you all for your patience. We have to realize that we haven't resolved a single thing except perhaps given a dimension of understanding to the problem that wasn't in the Congress before, and I appreciate all of your coming and your testimony very much.

This hearing stands adjourned.

[Whereupon, at 12:24 p.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

Frank
Lautenberg
United States Senator
for New Jersey

For Immediate Release
Feb. 28, 1986

For Further Information
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SENATOR LAUTENBERG OPPOSES OIL IMPORT FEE

FOR NORTHEAST-MIDWEST COALIATION

WASHINGTON -- Sen. Frank R. Lautenberg, D-N.J., said Friday he strongly opposes an oil import fee because it would damage his region and the economy as a whole.

"I am strongly opposed to an oil import fee," he said in remarks prepared for the Senate Finance energy and agricultural taxation subcommittee. "An oil import fee would take the steam out of the economy, chilling the growth we can look forward to as a result of lower oil prices."

Lautenberg said that the fee would be a burden in particular on residents of the import-dependent Northeast. In addition, he called the fee unfair to the poor.

"Low income households devote four times the share of their pre-tax income to energy than do upper income families," he said, in testimony on behalf of the Senate Northeast-Midwest Coalition. "It is a regressive tax."

And he called the fee highly inefficient, noting that it would "raise only one dollar in federal revenue for every three dollars, or more, that energy consumers will have to pay in higher energy prices." That is so because an increase in imported oil costs would prompt domestic oil and natural gas producers to increase their prices.

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TESTIMONY BY SENATOR FRANK R. LAUTENBERG
ON OIL IMPORT FEE

The Subcommittee on Energy & Agricultural Taxation
Senate Finance Committee February 28, 1986

Mr. Chairman, I am submitting this testimony on behalf of myself and many other Members of the Northeast-Midwest Senate Coalition on whose Steering Committee I serve.

I commend the Committee for holding these hearings. I also commend you, Mr. Chairman, for approaching this difficult issue in a very thoughtful and thorough fashion. I appreciate that you have maintained an open mind with regard to the merits of instituting an oil import fee.

The President said earlier this month that he is going to oppose tax legislation, that "in reality pits one American worker against another, one industry against another, one community against another, and that raises prices for us all.''

I think that hits the nail on the head when we talk about an oil import fee.

I am strongly opposed to an oil import fee. Such a fee would pit workers against each other, industries against each other, and communities against each other. And it would raise prices for all Americans, not just those most dependent on imported oil.

An oil import fee would take the steam out of the economy, chilling the growth we can look forward to as a result of lower oil prices. The fee would create an unfair and untenable burden on oil consumers, especially in the import-dependent Northeast. It is inappropriate energy policy, bad economic policy, and, for these reasons, not an effective deficit reduction policy.

Mr. Chairman, today's hearings occur under circumstances quite different those that existed when you introduced S. 1997. At that time, world crude oil prices had just started their tumble. Now, however, retail prices are starting to drop and homeowners, businesses, and industries alike are anticipating cheaper oil. Budget estimates and economic projections are likewise assuming the benefits that will flow from reductions in our national energy bill.

Since this idea has gained some currency in Washington, many noted economists have testified before your committee that an oil import fee would be detrimental to our economy and prospects for economic growth. It would reduce employment, divert capital from new investments, refire inflation, and retard growth. It would affect the price of gasoline, diesel, fuel oil, and aviation fuel and would ripple through the economy. Such a tax is good news for only one sector of the economy in one specific region. But, these narrow, regional gains would be at the expense of the vast majority of states, communities, and consumers of petroleum products.

In response to my questioning at the Senate Budget Committee, OMB Director James Miller made two points. He said, "I think that the effects of an oil import fee would be to slow our rate of economic growth." He also said, "I would be opposed to an oil import tax. If you accepted the notion you had to raise taxes, I think there are probably better ways of doing it...."

This testimony is supported by many economists, who have opposed the fee. Several recent studies have attempted to quantify the impact of an oil import fee compared to the impact of falling oil prices in the absence of such a fee. They all demonstrate the positive economic gains which we can look forward to as crude oil prices fall to levels lower than they have been since the 1970's. While some of these studies were conducted before the recent reduction in crude oil prices occurred, their results are still valuable in understanding the benefits that can flow from lower prices.

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One of the most enlightening of these studies was published in September 1985 by the Federal Reserve Bank of Dallas. In this study, Federal Reserve Bank economists Ronald Schmidt and Roger Dustan used a macroeconomic model to evaluate the impacts of an oil import fee. Their conclusion is clear: "If a tax increase is considered necessary to reduce the budget deficit, the macroeconomic results tend to argue against adopting an oil import tariff." Further, they conclude that in the long-term,a fee is unlikely to promote energy security because it would drain domestic oil at a time when foreign oil is cheap.

The Federal Reserve System's model of the economy to measure the impact of a theoretical $5 barrel fee on oil imports demonstrates that by not enacting a fee -- but rather letting prices reach their market levels - several benefits would accrue. Studies conducted by the Congressional Research Service (CRS), Wharton Econometric Associates, Data Resources, Inc., and the Consumer Federation of America yield similar results.

Let me summarize a few of the findings from these studies:

First, the GNP will be nearly 1 percent higher than it would be with a fee, according the Federal Reserve Bank and CRS studies.

Second, within three years, without a fee, employment will increase by 0.4 percent, according to the Federal Reserve Bank and CRS. This translates into a gain of 400,000 jobs.

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Third, lower oil prices will slow down the rate of inflation. Wharton Econometrics has estimated that falling oil prices will lower inflation by 1 percent. Expectations about lower inflation and interest rates, stemming from falling crude oil prices, have already been reflected on Wall Street. In contrast, FRB analysts Schmidt and Dunstan argue that the oil import fee would probably "bid up the prices of substitute energy products. These energy price increases would then force increases in the production costs of other goods." This, of course, means we would see no new relief from inflation.

An oil import fee is also an extremely inefficient way to raise revenues. An oil import fee would raise only one dollar in federal revenue for every three dollars, or more, that energy consumers will have to pay in higher energy prices.

This means that a $5 per barrel oil import fee, for example, would place a $25 billion drain on the economy each year. But, it would raise only about $8 billion in revenue. This excessive inefficiency and its consequential chilling of economic activity could potentially diminish any anticipated revenue gains. In fact, CRS has estimated that under certain conditions, an oil import fee may even result in a net loss of federal revenue.

The fee is so inefficient at raising revenue that an oil import fee of $5 per barrel would collect less in revenue than a 10 cent per gallon gasoline tax. Yet, it would raise gasoline prices more than a 10 cent a gallon gasoline tax increase.

An oil import fee would also inflict further damage on exporting industries and weaken their ability to compete internationally. A case in point is the petrochemical industry, which is currently quite competitive internationally and which uses large amounts of oil. U.S. exporters would be hit twice if an oil import fee not only raised their energy bills, but also resulted in retaliatory import tariffs.

Mr. Chairman, to this point, I have emphasized the adverse national impacts that I believe would flow from an oil import fee. In closing, I want to highlight that if the national impacts of an oil import fee are bad, the regional impacts--for the Northeast-Midwest region, and for my state of New Jersey--are devastating.

The most recent data available from the U.S. Department of Energy, indicates that, in 1983, the U.S. as a whole relied on oil for 43 percent of total energy needs. New Jersey's reliance was 59 percent. While only 10 percent of the energy used in U.S. homes in 1983 was supplied by oil, in New Jersey 24 percent was used. Industry nationwide was dependent on oil for 29 percent of its 1983 energy use. New Jersey's industries relied on oil for fully 48 percent of their energy use. Furthermore, states like New Jersey, which import most of their oil, will bear the most immediate brunt of a fee, just as New Jersey did during the energy price hikes of the 1970's. This pattern of heavy oil dependency for residential and industrial uses is repeated in many other states in the New England and Mid-Atlantic region.

The states in the Northeast-Midwest region do not produce very much crude oil, only about 2.5 percent of the national total. Therefore, our region would reap virtually none of the benefits created for domestic producers by a fee. In fact, if an oil import fee of $5.80 per barrel were put into place, it would increase prices to oil consumers by approximately $31 billion nationwide. About $10 billion of this would go to the Treasury, leaving the remaining $21 billion to fall to domestic producers. For the information of the committee, I would like to submit, for the record, a chart that contains a state-by-state distributional analysis of the impact of an oil import fee. It reflects both the cost to consumers, and the benefits to producers.

Mr. Chairman, there are additional reasons to oppose an oil import fee. It is a regressive tax. Low-income households devote four times the share of their pre-tax income to energy than do upper-income families. An oil import fee would penalize our allies, Mexico, Canada, Venezuela, and the United Kingdom, who have helped break the back of the OPEC cartel and who supply over half of our imported oil. It would lead to the premature depletion of domestic oil and gas resources and erode our long-term energy independence. Perhaps we should buy cheap foreign oil while it is available, and save ours for future needs.

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For the most of reasons I have discussed today, an oil import would be very harmful to the national economy, to my state, and to the entire Northeast-Midwest region. The fee would affect the direct consumer of petroleum products and those businesses, and their workers, that rely on oil. It would deny us our overdue relief from a decade of oil price shock.

The reduced oil prices on our hozizon promise to contribute to economic growth. Homeowners will have more cash available to make other purchases and industries will be able to reallocate capital into economically productive investments. We should encourage the efficient use of less expensive oil rather than institute an inefficient tax that will result in more expensive oil.

Thank you, Mr. Chairman.

Prepared by the NE-MW Institute

Consumer Impact of Energy Tax Alternatives Raising $10 Billion*
(in millions of dollars)

Region and State	$10 Billion Oil Import Fee: Producers' Windfall	$10 Billion Oil Import Fee: Consumer Impact[1]	$10 Billion Gasoline Tax[2]	$10 Billion Energy Tax[3]
New England				
Connecticut	0	478	127	95
Maine	0	254	50	49
Massachusetts	0	809	219	170
New Hampshire	0	125	39	26
Rhode Island	0	98	35	25
Vermont	0	60	23	15
Mid-Atlantic				
Delaware	0	117	30	26
Maryland	0	509	184	156
New Jersey	0	1,277	323	295
New York	6	1,781	530	470
Pennsylvania	28	1,288	428	462
Midwest				
Illinois	190	1,243	446	475
Indiana	36	683	239	310
Iowa	0	384	135	135
Michigan	201	787	300	332
Minnesota	0	534	192	170
Ohio	101	1,276	446	499
Wisconsin	0	482	195	181
South				
Alabama	130	486	161	169
Arkansas	125	314	108	107
District of Columbia	0	47	17	23
Florida	95	1,380	498	348
Georgia	0	730	283	296
Kentucky	51	481	168	176
Louisiana	3,394	1,476	210	455
Mississippi	216	339	111	113
North Carolina	0	678	290	220
Oklahoma	1,109	477	178	161
South Carolina	0	375	150	130
Tennessee	6	743	224	225
Texas	5,959	3,815	812	1,138
Virginia	0	651	249	210
West Virginia	23	195	78	95

Consumer Impact of Energy Tax Alternatives Raising $10 Billion*
(in millions of dollars)
(continued)

Region and State	$10 Billion Oil Import Fee		$10 Billion Gasoline Tax[2]	$10 Billion Energy Tax[3]
	Producers' Windfall	Consumer Impact[1]		
West				
Alaska	4.152	168	20	59
Arizona	1	317	137	107
California	2,714	2.905	1.067	817
Colorado	190	347	140	120
Hawaii	0	297	30	33
Idaho	0	112	43	48
Kansas	499	362	119	130
Missouri	2	600	245	197
Montana	196	140	44	42
Nebraska	42	211	75	73
Nevada	13	139	47	41
New Mexico	523	212	71	65
North Dakota	347	141	38	34
Oregon	0	356	118	114
South Dakota	9	112	37	28
Utah	228	184	66	69
Washington	0	554	186	218
Wyoming	818	170	33	53
U.S. Total	21.403	31.403	10.000	10.000

*All state figures based on 1983 percentages. The ratio of petroleum imports to total petroleum consumption is based on 1984 data.

[1] Averages $5.81/barrel on petroleum imports, assumes domestically produced oil price equals import price and averages 14.3 cents/gallon fuel oil and 12.6 cents/gallon gasoline. Although the price of oil affects the price of natural gas and coal as well, it is not possible to quantify the impact.

[2] Averages 9.9 cents/gallon gasoline tax.

[3] Averages 1.6 cents/gallon gasoline tax, 2.0 cents/gallon fuel oil tax, 14.5 cents/1000 cubic feet of natural gas, for example.

SOURCES: Staff calculations based on 1983 energy consumption by state from U.S. Department of Energy, Energy Information Administration, State Energy Data Report: Consumption Estimates, 1960-1983 (Washington, D.C., May 1985, passim). Oil import ratio to domestic production and price estimates based on U.S. Department of Energy, Monthly Energy Review, September 1985 (Washington, D.C., December 23, 1985). Windfall column calculated based on U.S. Department of Energy, Petroleum Supply Annual, 1984, Volume 1 (Washington, D.C., June 1985) p. 31.

STATEMENT OF EDWIN W. EDWARDS, GOVERNOR OF LOUISIANA AND CHAIRMAN OF THE INTERSTATE OIL COMPACT COMMISSION

Submitted to the Subcommittee on Energy and Agricultural
Taxation of the Committee on Finance, United States Senate

Thank you, Mr. Chairman. I am Edwin Edwards, Governor of the State of Louisiana and am appearing before you today in my capacity as Chairman of the Interstate Oil Compact Commission. The IOCC is the organization of thirty oil and gas producing states and six associate member states which for fifty years has advocated the conservation of oil and natural gas through sound engineering and production practices. All of the IOCC's operating funds are provided by its member states; it does not receive nor solicit funds from the industry.

The recent drop in crude oil prices has sent shockwaves through the domestic oil industry, heightening problems which still linger from the collapse of the oil exploration boom four years ago. The mere announcement of the first Treasury Department "tax simplification" plan significantly reduced investment in the oil field; the drop in prices can only serve to exacerbate the situation. Once again the American gasoline buyer finds himself AT THE MERCY of foreign governments which use oil supplies as tools of foreign policy to further national goals. While temporarily low gasoline prices might delight consumers today, the spectre of increased imports, an ever-increasing balance of payments deficit, wasteful use of petroleum products, and a national defense potentially held hostage to unstable foreign sources of crude oil will haunt us. A reduction in U.S. production is not simply a producing-state problem; through refining activities and manufacturing industries which depend upon petroleum, it reaches into every state in the nation.

I am here to support the imposition of an import fee on crude oil and petroleum products as proposed in S. 1507 and S. 1997. In his introductory remarks to S. 1507, Senator Boren stated, "Never has the case for an oil import fee been stronger." Mr. Chairman, the case is stronger now than could have been foreseen last July when S. 1507 was introduced.

Recent studies performed by the IOCC indicate that a significant number of stripper wells, those wells which produce on the average less than ten barrels per day, will be abandoned as the price of oil declines. Because of their marginal economic value, and unsuitability for enhanced recovery techniques due to low production, these wells are extremely sensitive to price changes.

In 1984, stripper wells accounted for 15% of the nation's oil production, and 70% of the total number of wells in the United States. This country is the only country which produces its marginal wells; the average stripper well produces less than 3 barrels per day.

The IOCC study shows that as the price of crude oil declines, the percentage of stripper wells abandoned as uneconomic increases. Assuming that the current number of stripper wells are economic at $25 per barrel, a $2 reduction in price would result in a 5% drop in the number of stripper wells, nearly 18 million barrels of production lost in the first year, and a drop of 24 million barrels in total lost reserves. Should oil prices stablize at $15 per barrel, the results would be catastrophic -- nearly 25% of all stripper wells would be abandoned, over 90 million barrels of production would be lost in the first year alone, resulting in a lost production value of $1.4 billion. Most significantly, 976 million barrels of total reserves would be forever lost -- 976 million barrels which would likely be made up by imports. Once a well is plugged and abandoned, it cannot be economically be brought back into production. While the most significant impacts of this reduction in stripper well production would be felt in the major producing states, some impacts would be noticed in nearly all oil-producing states in this country. A copy of the IOCC study is included as an addendum to my remarks.

In a study performed at Southern Methodist University and released by Senator Bentsen, the impact of falling prices takes its toll in other ways. It was estimated that for each $1 drop in crude oil prices, 25,000 jobs would be lost in Texas, the gross state product would fall by $3 billion, and $100 million in states revenues would be lost. A drop to $15 a barrel would result in Texas losing 250,000 jobs, $30 billion in purchasing power, and $1 billion in revenues. Extending these figures to ten producing states in the lower 48, it would take away 430,000 jobs, reduce purchasing power by $60 billion, and reduce state revenues by more than $2 billion.

It must be remembered that many financial institutions have a huge stake in the oil industry. This effect is not limited to the oil states; the Penn Square Bank episode taught us how widespread the impact could become. Banks in New York, Chicago, and Seattle were sent reeling. A stable price significantly below last year's could have similar impacts.

These irreplaceable losses in reserves will severely impact this nation's ability to provide petroleum products for its consumers. At present, 42% of our total energy needs are met by oil; in the year 2000, oil will still be needed to provide 30%. We have sufficient supplies of coal, natural gas, and nuclear power to meet those fuels respective shares fifteen years from now. What we do have in this country is a shortage of liquid fuels -- fuel to run automobiles and transportation systems, to heat homes in the Northeast, to supply the defense of this nation. No substitute exists as of yet for this fuel requirement -- a ton of coal will not make a fighter plane airborne. Declines in production have occurred in nearly all major producing states; in California, this decline has been arrested only through extensive enhanced oil recovery projects by steam injection. Clearly, a significant drop in prices will intensify and hasten the decline.

Only enhanced recovery techniques offer the promise of arresting this decline and allowing for stable supplies for the next twenty years for the lower 48 states. The IOCC has initiated a study to determine what incentives states might offer to encourage EOR; a preliminary study for the State of New Mexico indicated that certain incentives at $24 a barrel could produce, through enhanced oil recovery, the same increase in reserves through EOR at $28 a barrel with no incentives. However, with prices falling so low even generous incentives will not assist in developing EOR projects in marginally economic fields.

It is inconceivable that this nation would consciously allow depressed oil prices to threaten its ability to defend itself; the abandonment of marginal wells and reluctance to initiate enhanced recovery projects at low prices could place us in the unenviable position of depending upon foreign sources for a larger share of defense needs for crude oil. Our planes, field equipment, and many of our ships depend upon liquid fuels; these fuels can only be obtained from oil. Should an emergency occur, and the United States is faced with the prospect of significantly reduced import supplies of crude oil, it will be required to make drastic reductions in the availability of supplies to the civilian population. In a worst case scenario, we may not have the industry capability remaining to quickly increase our domestic production to meet the demand. We seem to have forgotten the significant role that the domestic oil industry played in the victory in World War II.

All of this leads to the point of these hearings and this testimony -- it is essential that the Congress enact an oil import fee for crude oil and petroleum products. This should take the form of a fee of a specific amount, which is set to phase out entirely at a given crude oil price. Such a fee would raise the price of crude oil to a more reasonable level for production and exploration in this country, but would not continue beyond what is necessary to establish that reasonable price, and encourage inflationary pressures. The proposed fee in petroleum products will prevent foreign suppliers from simply shifting their resources to refined products rather than crude oil, and undercutting our efforts to ensure a viable domestic supply.

The IOCC supports the concept of rebates for certain users of imported crude oil. Those persons in the northeastern part of the United States who are dependent upon home heating oil for their heating needs during the winter months should be rebated the excess amount brought on by the import fee. The rebate could be distributed to the states, and they could then distribute the rebate according to need, to assist those most unable to afford increases in heating costs. Additionally, rebates for those industries which utilized imported oil for manufacture of products destined for import should also be subject to rebate, in order not to place them at a competitive disadvantage with other companies in foreign markets.

I cannot overemphasize that this legislation has national implications which are positive and benefit all of this nation's citizens. We cannot afford to have our defenses crippled because of shortsightedness. We cannot afford to waste millions, and perhaps billions, of barrels of oil by forever abandoning them in the earth. We cannot afford to place ourselves at the mercy of foreign nations who supply so much of a product so necessary to our national well-being. In spite of our advances in new energy technologies, oil will still be needed years from now as an essential fuel source for many sectors of our economy. We do ourselves a disservice by praising low prices on a few petroleum products today without examining this impact on this country's security and well-being in the long term. The oil import fee is not a producing state bill -- it is not an industry relief bill -- it is legislation to help ensure adequate supplies of crude oil for this generation and future generations.

STATEMENT OF CONGRESSMAN ANTHONY C. BEILENSON
BEFORE THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE FINANCE COMMITTEE
FEBRUARY 28, 1986

Mr. Chairman, I appreciate the opportunity to address the subcommittee on the subject of an oil import fee.

The recent steep drop in oil prices has focused attention on taxing imported oil and petroleum products both as a way of protecting our domestic oil industry from having to compete with lower-priced foreign oil and as a way of raising federal revenue. But protecting prices for the U.S. oil industry is bad economic and trade policy, and there are better ways to raise revenue from oil than through an import fee. For those two reasons, and because an import fee would bring about other adverse consequences, too, I urge you to reject the import fee bills before you and to consider, instead, raising the Federal excise tax on gasoline.

Congress should not try to protect the oil industry by imposing a tariff on imports. Protectionism for oil, as for virtually any industry, would cause our domestic industry to lessen its efforts to become more efficient and internationally competitive. Regulation of oil prices was a bad idea when prices were climbing, as they did rapidly in the 1970's; it's a bad idea now that prices are dropping.

Furthermore, providing an economic advantage for our own oil industry would cause serious problems for the countries from whom we import the most oil: neighbors and other friendly countries such as Canada, Mexico, Venezuela, and Great Britain. Because of its severe debt situation, Mexico would probably be granted an exemption; but then other allies would want the same treatment and deciding which ones merit an exemption would cause problems for us. The more countries that are exempted, the less the fee would produce the desired results.

The other primary purpose of an oil import fee is to raise revenue. Congress should take advantage of dramatically lower oil prices to generate federal revenue, because taxing oil is one way we can reduce the budget deficit relatively painlessly. However, of the various energy taxes being discussed, an import fee is the least efficient and most economically dangerous alternative.

With an import fee, domestic producers would raise their prices to match the higher price of imported oil. Although all oil would rise in price, only $1 out of every $3 or $4 in increased prices would be collected as federal revenue--the rest would result in an inexcusable windfall profit for domestic oil companies.

In addition, an import fee would raise the price of all oil products, increasing economic costs across the board, from home heating to manufacturing. Those who heat their homes with oil would unfairly bear the double burden of higher heating and driving costs. Manufacturers who use oil would find it harder to compete in world markets.

Furthermore, an import fee--especially one drawn with exemptions for certain countries and for certain products--would require complex regulations which would take months or even years to implement. By the time it takes effect, the price of oil could be climbing again.

A far better way to raise revenue from oil is to increase the Federal excise tax on gasoline. A higher gasoline tax would have none of the above-mentioned disadvantages. There would be no protectionism problems, because the gasoline tax would apply to both domestic and imported gasoline. It would be a much more efficient way to raise revenue, since the government would collect every penny of the higher cost of gasoline. Since it would only affect transportation costs, it would not raise the costs of manufactured goods or heating oil. And, because a federal gasoline tax already exists, a higher tax would be simple to administer and could be imposed immediately upon enactment.

The biggest disadvantage of a gasoline tax, compared to an oil import fee, is public perception of it. People tend to think of a gasoline tax as a tax on them, and an import fee as a tax on foreign oil producers. But the fact is, prices at the pump would rise under either alternative; and under an import fee, people would not only face higher gasoline prices but also increased prices for heating oil and most manufactured goods.

However, it is possible to the gasoline tax without raising prices at the pump above levels people have become accustomed to paying. All we have to do is raise the gas tax at the same rate that the price of oil drops.

Under a bill that several of us have introduced in the House

(H.R. 4117), every time the price of a barrel of oil drops by $1 from its January 1st price of $27 a barrel, we would increase the gasoline tax by 2.4¢ a gallon (the equivalent amount). When the price of oil rises again, the tax would be lowered at the same amount. All of the proceeds of this additional gas tax would go to the general fund, to be used to reduce the federal deficit, rather than to the highway trust fund.

With this adjustable tax, drivers would pay no more for gasoline than they paid in January, and yet we would raise a substantial amount of revenue. Each additional cent per gallon raises about $1 billion annually so if, for example, the price of oil stabilizes at $17 a barrel, we would raise $24 billion a year. That amount is enough to meet more than half the anticipated FY 87 deficit-reduction requirement called for under Gramm-Rudman.

I strongly urge your consideration of the adjustable gasoline tax as proposed in H.R. 4117. It's a much better way to raise federal revenue than imposing any of the oil import fee proposals now before you.

Mr. Chairman, thank you again for the opportunity to express my views on this matter to the subcommittee.

A STATEMENT FOR THE SUBCOMMITTEE ON OIL IMPORTS (SENATOR WALLOP, CHAIRMAN)

AD HOC COMMITTEE FOR AN OIL IMPORT TAX

A Critical Situation

Plunging world oil prices have created the following conditions;

1. The U. S. oil industry is in disarray. A significant number of oil operations are being shut down. In Texas alone, it is estimated that a $15 oil price will cause the loss of 250,000 jobs. The number of operating rigs, which had previously declined from a total of 4500 to less than 2000, will probably suffer a 60%-70% decline. Development drilling is being cut back; exploration is drastically reduced; and virtually all major projects are in suspense or grinding to a halt.

The effect of oil prices fluctuating between $10 and $20 a barrel will cause a shutdown of a vast number of stripper and marginal wells, curtail secondary recovery, cause a reduction in maintenance of existing wells and the drilling of wells in existing fields, and restrict funding of exploration projects for all but shallow wells. Estimates are that, within a year, U. S. production will fall 1,000,000 to 2,000,000 barrels a day from an existing total of about 8,000,000 barrels. This will necessitate increased imports of oil and add to the trade deficit.

2. A major part of the U. S. banking system, including but not limited to the banks in energy productive states, are experiencing alarming losses in collateral value. A significant number of banks, both in small towns and regional financial centers, will be in danger of loss of all or a major part of their net worth, and either be closed or require take-over by the FDIC or funding by the

Federal Reserve System. On a minimum basis, the loss of collateral value will severely restrict the ability of banks to provide banking services for the general public quite apart from the oil industry.

3. The states and local governments in oil producing areas will be deprived of a major part of their necessary funding. For example, the Longview School District in Texas is said to obtain more than 80% of its receipts from oil sources. This will result in major curtailment of services, and substantial increase in taxes on non-oil related transactions.

4. National security will be endangered if U. S. based production and exploration is severely reduced. While the U. S. maintains a 4-month supply of reserve oil, useful for immediate needs, a long-term reduction in oil development within the United States will make the country dependent on outside sources for essential fuel for planes, tanks, and all other aspects of military operations. Declining U. S. reserves, due to reduced exploration, will render the U. S. less able to maintain a strong world position.

5. It has been estimated that the U. S. Treasury will lose up to $40 billion per year in tax collections due to loss of jobs and earnings in oil producing states. This will put additional pressure on the national deficit.

6. Energy conservation plans and objectives will lose ground as oil consumer prices decline. While crude oil prices decline sharply, prices at the gasoline pump will decline only moderately as states add excise taxes, and refineries and distributors of oil products increase their operating margins. The consumer may benefit from less than half the drop in world oil prices. Meanwhile, U. S. oil conservation programs will slide, oil consumption increase, and oil production decline. Within a relatively few years, U. S. oil

consumption will have increased significantly and oil production will be reduced in a major way.

A Proposed Oil Import Tax

To counter this situation, it is proposed:

1. The U. S. impose a tax of $10 per barrel on all oil imported into the United States, and a comparable tax on imported refined oil products. There would be no exemptions to this tax.

2. Revenues of $16 billion annually collected by the U. S. would be available as revenue for the tax reform bill which has been passed by the House and is now under consideration by the Senate Finance Committee. These revenues might, for example, be used to accomplish the President's goals for the tax bill, while also continuing the deductability of state and local taxes, permit restoration of the investment tax credit, and allow other provisions which would have a positive effect on the economy. A portion of the oil tax revenue might be set aside for industries which prove that the extra costs attributable to the import tax make their products less competitive than the competing products in the world market.

3. Because of the urgency of the problem, consideration should be given a prompt passage of a motion by the Finance Committee adopting the oil import tax, and setting an immediate effective date. The current tax bill has several effective dates which are already applicable and pertain to various provisions of the law as it will be passed by the Congress.

Effect Of The Proposal

The proposal would have the following effects:

1. It would immediately establish a $10 a barrel differential between the world price and the U. S. domestic price. At a

world price of $15, the effective U. S. price would be $25 per barrel, a price well below the recent price of $30 in the United States, but nevertheless high enough to maintain the reduced level of the U. S. oil industry prior to January, 1986, and to maintain collateral for banking institutions.

2. While there may be some continuing decline in the oil industry if, for example, the world oil price declines to $10 a barrel, the dimensions would be manageable. The U. S. oil industry would be affected by world oil prices in the range of $10 to $20 a barrel but could live with this range of volatility.

3. The consumer would not be significantly affected because major price reductions have not yet taken place and are likely to be absorbed, in any event, by state and local authorities and intermediate parties to oil distribution.

4. Foreign countries would not be significantly affected because they would still sell their oil at the world prices. The U. S. would continue to buy as much oil from abroad as it has in the past. The world price is affected by a temporary world oversupply, and the need of most sellers to maximize their cash sales. Unless those countries agree to a worldwide cutback of sales, and honor those commitments, the world oil price will stay in a depressed condition until the high-cost producers are forced out of business, or countries with limited reserves exhaust their supplies. If the U. S. fails to set itself apart from the world oil market by means of an oil import tax, it will be one of the countries forced to abandon its high-cost production, such as stripper wells, secondary recovery, and high cost exploration projects.

5. With a more stable U. S. oil price, the U. S. banking industry will remain sound, U. S. Treasury tax collections will

remain high, and U. S. position in the world will be stronger than ever. Increased confidence in the ability of the U. S. to manage its own affairs will contribute to a reduction in the continuing decline of the dollar.

6. The passage of the tax reform bill with major tax reductions for individuals, and less rigorous provisions for business, will stimulate the general economy.

7. Alternatively, of course, the $16 billion Federal revenues from the import tax could be used to reduce the Federal deficit.

8. In summary, the oil import tax as proposed will benefit the entire country.

Answers to Specific Points Raised About the Oil Import Tax

1. An exemption should be made for Mexico because of adverse effect of lowered world prices on that country, and because of its proximity to the United States.

Answer: No exceptions should be made for Mexico or other countries. To allow Mexico or any other country to bring in oil at the higher price would a) create an irresistable demand for other exemptions, and b) in effect, put U. S. tax dollars in the hands of a foreign country. The Mexican problem, while acute, needs its own resolution. If dollars are to be funded to Mexico, they be paid directly under a controlled program.

2. An exemption should be made for heating oil used in the northeast U. S., or oil used in other parts of the country.

Answer: An exemption made for any type of oil used in one part of the country would create serious administrative problems as such oil is shifted to other parts of the country. The price benefits of lower oil prices to such users would not be nearly as much as anticipated. If specific needs arise for the poor, portions of the $16 billion revenues could be allocated as part of the "safety net" program.

3. The Arab countries and other oil producers will be angered and take action against the United States.

Answer: There is no justification for foreign countries viewing the oil import tax as action taken against them. The U. S. would still pay the world price for oil. The oil import tax is levied on the U. S. market, and for the purpose of maintaining high-cost U. S. production and exploration. The U. S. now has lower internal oil taxes than most countries in the world, and with this tax would continue to have relatively low internal oil taxes. It is true, of course, that Arab countries would eventually have more oil to sell to the U. S. if U. S. production and exploration is hobbled. But causing devastation to the U. S. oil industry, and other adverse economic effects in the U. S., makes the U. S. a less secure and stable ally. The long-run interest of both OPEC and non-OPEC oil states is in a United States that is strong both in terms of oil production and economic well-being. World oil problems will be solved only when OPEC and non-OPEC countries agree to equitably share the demand for oil. That is not a likely scenario, but until it occurs, the U. S. must maintain its own production and exploration programs.

4. Instead of the $10 a barrel import tax, the U. S. should set a price of $22 and $25 a barrel, and impose a tax of the differential between the purchase price on the world oil market and the U. S. set price.

Answer: This is an administrative nightmare. Profits would be siphoned off on oil reaching U. S. shores and the U. S. revenue collections of $16 billion annually would disappear. Furthermore, it is, in effect, price control, depriving the consumer of lower prices if world oil prices continue a steep decline, and depriving producers of an incentive to explore and drill for oil, hoping for a higher price.

5. Any oil import tax should be applied against the Federal deficit and not to make the tax reform bill neutral.

Answer: This is a major political issue. The oil import tax of $10 a barrel and the $16 billion annual revenue will be the same regardless of the method of applying the funds. However, President Reagan has taken a stand against any general tax increase. Since the tax bill would be a major economic boon to U. S. citizens generally, it is the recommendation of the Committee that the $16 billion annual revenues be applied in that fashion.

6. The leading oil industry associations, American Petroleum Institute (API), and Independent Petroleum Association of America (IPAA) have taken a position adverse to an oil import tax.

Answer: Both of these associations adopted that position when oil was selling at $30 a barrel and there was no need for an oil import tax. For example, the IPAA group made their decision at an annual meeting in November 1985 in San Antonio, 45 days before the serious oil price drop began. Subsequent to the rapid oil price decline, several industry trade associations such as Texas Oil Producers and Royalty Owners (TIPRO), the Permian Basin Oil Association and many others have strongly supported the oil import tax.

7. The oil import tax will lead to further government regulation of the oil industry and a windfall profits tax.

Answer: The oil industry is already heavily regulated and a windfall profits tax is already in effect. It would be unreasonable to impose any additional windfall profits tax when the oil industry is reeling from prices that have declined from $35 a barrel, and the rig count and exploration activities are well below the amount needed to maintain oil production, let alone increase domestic reserves.

8. An oil import tax will make the U. S. less competitive in international markets.

Answer: The actual impact of an oil import tax on goods sold in international trade would be negligible. Energy costs are not significant in major U. S. exports such as Boeing airplanes and pharmaceutical products. In the case of other products where energy may be more of a factor, such as specialty chemicals or farm products, a fund could be set aside to provide reimbursement when it is proven that the total U. S. tax burden or energy usage is significantly greater than the tax burden on similar products from competing countries.

9. President Reagan has stated that he is opposed to imposition of an oil import tax.

Answer: The President has at times indicated that the oil import tax would be acceptable as a means of making the tax reform bill "neutral" in revenue effects. He has subsequently taken the opposite point of view. However, the fact of the matter is that the tax reform bill is seriously deficient in revenue impact -- to the extent of $10 billion to $15 billion annually. Without an oil import tax, the Committee will find it necessary to turn to disallowing deductions, in whole or in part, for state income and property taxes, or disallowing corporations a part of their deductions for interest, or a tax on advertising expenses -- all of which are vastly more objectionable and detrimental to the whole economy than the oil import tax. The necessity and desirability of an oil import tax -- both from the point of view of national security and revenues to the Federal government -- is an issue that will not go away and will continuouosly become more acute.

Ad Hoc Committee for an Oil Import Tax

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JPD:JM

Statement of

The Associated General Contractors of America

Presented to the

Subcommittee on Energy and Agricultural Taxation

of the Finance Committee

United States Senate

on the Topic of

Taxation of Imported Oil

February 27-28, 1986

AGC is:

- More than 30,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 110 chapters nationwide;

AGC members complete:

- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America represents more than 30,000 firms, including 8,400 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 individuals. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities.

The construction industry has great concern regarding the imposition of an import fee on crude oil and refined petroleum products.

The construction industry is a major consumer of refined and petroleum-based products. Approximately half of the petroleum products consumed by the construction industry is for the operation of construction equipment.

The other half of petroleum-based products consumed by the construction industry is asphalt related. This category includes asphalt used in roofing, but, by far, the greatest amount of asphalt used in the construction industry is for highway construction and highway maintenance work. Over 80% of all the asphalt used in highway construction in the United States is used in federally funded highway construction and maintenance programs. A dollar increase in the price of a barrel of oil will result in an approximate seven dollar increase in the price of a ton of asphalt.

Procurement in the construction industry is based on open competitive bidding and the firm fixed price contract system. These fixed price contracts may take two, three or four or more years to complete. Once the low bid is accepted and the contract is awarded, a contractor is committed to accomplishing the contract at the firm bid price. The contractor does not have the opportunity, like firms in other industries, to increase the contract price to reflect increases in the cost of materials or fuel. Contractors who have bid for work prior to an import fee on crude oil would stand to lose millions of dollars due to the price increase in fuel and petroleum-based products that would occur with the imposition of oil import fees.

Contractors with long-term firm fixed price contracts would be unfairly penalized by an import fee on imported crude oil. While contractors must assess and price accordingly the costs of demand and supply situations before winning contracts through open competitive bidding, they should not be penalized by actions of their own government after contract award.

The construction industry, based on open competitive bidding and the fixed price contract system, suffered severely as a result of fuel price increases caused by the Mid-East oil embargo and should not now, or in the future, be penalized by actions of our own government. Consequently, provisions must be established by law or regulation to rebate to the contractor the increased costs in hydrocarbons and their derivative products on fixed price or guaranteed maximum price contracts bid or entered into prior to the implementation of any government energy program which results in increased prices in hydrocarbons or their derivative products.

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA
Before the Committee on Finance
Subcommittee on Energy and Agricultural Taxation
on the Oil Import Fee proposals
February 27 and 28, 1986

The U.S. scheduled airlines, on behalf of millions of passengers and thousands of shippers, oppose energy taxes that could cost the airline industry alone more than $1 billion a year -- more than the industry earned last year.

The airlines are a substantial consumer of petroleum products, using about 12 billion gallons of jet fuel in 1985 at a cost of $9.5 billion.

Jet fuel accounts for about 22 percent of the total operating costs of an airline, 35 to 50 percent of the cost of operating each jet aircraft.

A tax on imported crude oil and petroleum products of $5 per barrel would increase jet fuel costs by as much as 12¢ per gallon, or nearly $1.5 billion a year for the entire airline industry, assuming that the price of domestically produced oil rose to the price floor created by the tax. Cost increases of this magnitude would increase ticket prices.

An ad valorem tax on all fuels based upon Btu content would also have a serious impact on the airlines, although not so drastic as fees or taxes confined to petroleum products because other energy consumers would bear part of the burden. A tax of 17¢ per million Btu – the revenue-generating equivalent of a $5 per barrel fee on imported oil, according to the Congressional Research Service – would cost the airlines approximately $200 million a year.

A motor gasoline tax would have only limited impact on the airlines, although it would adversely affect many other elements of the travel and tourism industry.

For an industry that is only now returning to profitability after losing over $1 billion during the early 1980's, and which is facing major restructuring as the full effects of deregulation are being felt, imposition of new energy fees or taxes would be a difficult blow to absorb.

The rapid fall in oil prices worldwide will provide U.S. consumers with the first major decrease in energy prices in over a decade. For each $1 decrease in the price of oil, inflation will drop by two-tenths of a percntage point and will swell the gross national product by one-tenth of 1 percent, according to a recent study by the Center for Enterprising at Southern Methodist University commissioned by Senator Lloyd Bentsen. For manufacturers and others hard hit by foreign competition, the fall in oil prices brings with it the promise of the first real recovery of this decade.

The airlines are concerned that a tax on imported oil will mean that energy consumers around the country will not share equally in the proposal's cost. An oil import fee is a badly designed tax on consumption that only impacts energy intensive petroleum users, like steel, petrochemicals, utilities, and transportation. The effect on air transportation will be especially severe.

Since the worldwide oil crisis in 1974, the price of oil has climbed from $4 to over $30 per barrel in late 1985, a 700 percent increase in 11 years. The price of jet fuel per gallon rose from 13¢ in 1973 to an average of 80¢ in 1985.

Each 1¢ per gallon increase in the price of jet fuel adds over $120 million annually to airline fuel costs. From 1973 to 1985, the airline industry's annual fuel bill increased from $1.4 billion to $9.5 billion.

During this period, the airlines became much more efficient in their use of fuel. More fuel efficient aircraft, like the Boeing 737 and McDonnell Douglas MD9-80, were purchased, more seats were added to existing aircraft, routes were restructured, and aircraft use was increased and weight was reduced. Through these measures, airlines carried 104 percent more traffic in 1985 than in 1973 while using only 12% more fuel.

The airlines have been able to pass along these savings to their customers in the form of reduced costs. Increased efficiencies and the competition brought by deregulation have brought the nation a period of extraordinarily low prices for air transportation in many markets. Such savings will be jeopardized, if not immediately erased, by an oil import fee.

To achieve further efficiencies, the airlines must continue to purchase fuel efficient aircraft. The airlines currently have 562 aircraft on order or under option worth $25 billion; in the next five years, they will need to purchase additional aircraft at a cost of over $50 billion. The imposition of new fuel taxes will make the acquisition of new aircraft more difficult, however, as capital intended for investment goes instead to meet fuel costs.

Imposition of fees or taxes would place a severe burden on the airlines, their passengers and shippers during a period of financial difficulty for many carriers and major restructuring for the entire industry. Not only would the financial health of the industry again be placed in jeopardy, but also the recovery of the entire national economy.

The Air Transport Association of America urges Congress and the Administration to reject inequitable new energy taxes.

BOSTON EDISON COMPANY
EXECUTIVE OFFICES
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STEPHEN J. SWEENEY
PRESIDENT
AND
CHIEF EXECUTIVE OFFICER

March 5, 1986

The Honorable Malcolm Wallop
206 Senate Russell Office Building
Washington, D. C.   20510

Dear Senator Wallop:

I would like to place on record Boston Edison's opposition to an imported oil fee which is under consideration as a new tax source at the federal level and was the subject of recent hearings before your subcommittee in Washington, D. C. Boston Edison, in the wake of the Arab Oil Embargo of 1973-74, reduced its dependency on oil for electric generation from approximately 13,960,000 barrels in 1973 to 7,120,000 barrels in 1985. Yet, oil purchases remain a substantial portion of Company costs and last year comprised almost 40% of all fuel and purchased power costs.

In 1985, the Company's oil purchases cost approximately $190 million. An import fee of $5 per barrel, assuming flow-through, would have increased this amount by $35.6 million or approximately 19%. Obviously, any fluctuation in the price of oil has a marked impact on our electric generating costs and, in turn, the electric bills of the 600,000 customers we serve in the Boston area.

The decrease in oil consumption over the past ten or more years at Boston Edison has not been accomplished without additional expenditures for new plant and equipment, as well as innovative thinking on the part of the Company in obtaining other fuel and energy sources. Now, when the price of oil is moderating, primarily because of an oversupply and a leveling off of consumption world wide, our customers could be denied the economic effects brought about by the marketplace, which in this case is beneficial to New England if not the country, as a whole. Although this statement may appear contrary to accepted thinking, there is growing evidence that domestic oil producers may in fact find that lower oil prices are more than offset by faster economic growth and the possibility of lower interest rates.

Our concern, however, extends beyond the obvious impact that such a tax has on imported oil costs since such a fee will, undoubtedly, also increase domestic oil and other competing energy sources on a comparative basis, but also increase the cost of petroleum by-products such as insulating oils for transformers and pipe-type cables, which are vital to our business.

The effects of this upsurge in energy and product prices would be particularly burdensome to electric utilities such as Boston Edison who, in the short term, have no alternative but to pay the higher prices. These increases would in turn raise customer costs both in the residential as well as the industrial-commercial markets.

As Massachusetts households, according to 1983 data, are amongst the highest users of oil in the U. S. (14.02 bbls per household vs. 4.3 bbls per household nationwide), additional oil costs would result in a more disproportionate share for Massachusetts consumers. In the industrial sector, energy users would either have to increase product prices or substitute other resources (capital and labor) as an offset to higher energy costs. This process would result in a less productive mix of inputs and a diminished growth in real Gross National Product.

According to a recent study conducted by the Congressional Research Service, an oil import fee would have a severe impact on the Gross National Product resulting in slower growth and higher unemployment. The Congressional Research Service data determined that a $5 per barrel oil import fee would result in average annual losses in the Gross National Product of $19 billion for the period 1988 to 1990. Economists have already forecast that this period 1988 to 1990 will have significant unemployment and income losses that reflect a downward trend in the Gross National Product without the enactment of an oil import fee.

American industrial products would become even less competitive, and foreign imports more attractive, because energy is a key input to every U. S. industry. Higher energy prices would increase domestic manufacturing costs at a time when the nation is experiencing huge trade deficits and is actively engaged in trying to reduce that imbalance. Thus, an oil import fee would make it even more difficult for U. S. industries to compete with foreign counterparts.

If an oil import fee or tax were to be implemented, it would make the cost of doing business in this and other oil dependent areas difficult at best. Not only would electric costs increase, as well as the costs of other fuel-related products and services, but such a fee would, as the result of increased prices, effectively eliminate New England's competitive edge in domestic and world markets. It would discourage new businesses, investments, and new jobs from coming to New England. But more importantly, it would destroy the current economic prosperity that is flourishing in New England and which is the envy of the entire nation.

An oil import tax, five years after the freeing of domestic crude oil prices from federal regulation, and a year after the partial decontrol of natural gas prices, would again result in the government's setting artificial oil and other energy prices. This would inevitably cost consumers more than they would otherwise pay for energy over and above the tax itself.

Rather than imposing an oil import fee as a means of raising tax revenues or for deficit reduction purposes, not to mention its inequitable distribution amongst U. S. consumers, we believe that other more fairly based revenue raising approaches or cost reduction programs can be implemented at the national level with less disruptive effects. Concern over the size of the current federal budget deficit is fully justified, but an oil import tax would be an erroneous substitute for biting the bullet on either a broader based tax or reduced government spending.

Sincerely,

Stephen J Sweeney.

CANADIAN PETROLEUM ASSOCIATION
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SUBMISSION TO THE
UNITED STATES SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
REGARDING REVIEW OF PROPOSALS TO TAX IMPORTED OIL

March 5, 1986

The Canadian Petroleum Association comprises companies engaged in oil and natural gas exploration, production, and pipelining in Canada. Its member companies collectively account for over 85% of Canada's crude oil production, of which more than one-third is exported by pipeline to the United States. The Association, therefore, is vitally interested in the proceedings of the Committee regarding the proposed imposition of a tax on crude oil and refined petroleum products imported into the United States.

Canadian crude oil producers have since June 1985 operated a business environment where oil prices and oil trade are determined by the marketplace. Companies are now essentially free to import and export crude oil as market opportunities arise. Canadian producers are no longer guaranteed domestic markets for their crude oil; at the same time, they can pursue market opportunities in the United States and elsewhere.

This market-oriented system is a relatively new phenomenon in Canada. From late 1973 until June 1985, Canada had a system of government-administered oil prices which resulted in an inflexible and complex system of import compensation and export taxes, and export/import volume restrictions.

In keeping with a market-oriented trading system both Canada and the United States are encouraging increased trade and investment flows between the two countries through the private sector. The Quebec Summit meeting of March 1985 agreed to liberalize trade between Canada and the United States, including energy trade. The final Summit communique contained the following statement:

> "We have also directed that action be undertaken ... to resolve specific impediments to trade ... and will concentrate intitially on:
>
> - Strengthening our market approach to Canada - United States energy trade by reducing restrictions, particularly those on petroleum imports and exports, and by maintaining and extending open access to each others' energy markets, including oil, natural gas, electricity and coal."

Canada and the United States have historically enjoyed a mutually beneficial trading relationship with respect to oil and natural gas. According to the Department of Energy, Energy Information Administration, imports of Canadian crude oil and petroleum products averaged 756 000 barrels daily in the first eleven months of 1985, making Canada the second largest single supplier. The U.S. market has become an important outlet for Canadian heavy crude oil, and in recent years again a growing market for light and medium crude oil. Canadian natural gas also has long filled an important segment of U.S. demand on a reliable basis, and has been especially beneficial to the U.S. during peak seasonal requirements.

A measure of Canada's increasing importance as a supplier of crude oil and petroleum products to the U.S. is the significant volume growth in recent years. While supplies dropped in the early 1970s due to global market conditions, Canadian exports to the U.S. started to grow again in 1982 and have since risen steadily to the current level. During 1986, it is estimated that crude oil alone will supply over 500 000 barrels daily to the U.S. market. These supplies provide an important and secure source of oil for U.S. users at competitive prices.

At the same time the Canadian industry is undertaking significant new investments directly related to the supply of crude oil to the United States. Large investments are underway or planned to increase the production of heavy oil and bitumen. Investment in projects currently producing, under construction, or planned total over $2 billion initially, with additional billions required during their producing life.

In order to move the additional heavy oil production, Interprovincial Pipeline, Canada's major west-to-east crude oil carrier, is planning a $300 million expansion to provide additional pipeline capacity, primarily to supply U.S. northern tier markets; and further expansion is under consideration.

It is important to note that significant investment both by the U.S. Northern Tier refineries and in Canada by heavy oil producers has taken place in recent years to maximize the mutually beneficial economics inherent in a north-south oil trade.

The imposition of a tax or higher tariffs on crude oil and petroleum products imported into the United States would be counterproductive and would undermine the Quebec Summit commitment to liberalize Canada/U.S. trade relationships. It would also be inconsistent with the 1985 IEA Ministerial resolution regarding energy trade which reaffirmed the Ministers' commitment "to the open multilateral trading system and their determination to strengthen it by further liberalization".

The Canadian Petroleum Association, for the foregoing reasons recommends against the imposition of an oil import tax or higher tariffs.

Statement of the Chamber of Commerce of the United States

ON: LEGISLATIVE PROPOSALS FOR
A TAX ON IMPORTED OIL

TO: SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION OF THE
SENATE COMMITTEE ON FINANCE

BY: SUSAN L. CONNOLLY

DATE: MARCH 14, 1986

The Chamber of Commerce of the United States is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents almost 180,000 businesses plus several thousand organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 57 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 12,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
LEGISLATIVE PROPOSALS FOR A TAX ON IMPORTED OIL
for submission to the
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
of the
SENATE COMMITTEE ON FINANCE
by
Susan L. Connolly*
March 14, 1986

The U.S. Chamber of Commerce is pleased to have the opportunity to comment as the Committee considers legislative proposals for a tax on imported oil.

The Chamber strongly opposes any new energy production or use taxes, including an oil import fee or increased federal tax on gasoline. This position has been reviewed twice by the Chamber's Board of Directors during the past four months. Each time the Board voted to oppose such taxes.

It urges opposition to S. 1997, introduced by Senators Wallop and Bentsen, to establish a $22 per barrel floor price for the imposition of a tax on imported oil; S. 1507, introduced by Senator Boren, to levy a $5 per barrel tax on imported crude oil and a $10 per barrel tax on refined petroleum products; and any other energy tax proposals offered as a means of reducing the federal deficit, keeping the tax reform bill "revenue neutral," shoring up the price of domestic oil, promoting energy independence, or other purposes.

The Chamber believes an oil import fee, such as those called for in the Wallop/Bensten and Boren proposals, would deny Americans much of the economic benefit resulting from declining oil prices. While an oil import tax would raise revenues, we caution that the actual revenues to the federal Treasury would be less than the static revenue estimates indicate. Further, an oil import tax would be discriminatory and regressive, hurt the overall economy, create competitive imbalances, and penalize our allies. Our reasons for these conclusions are elaborated in the following three sections.

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*Manager, Energy and Natural Resources Policy, Resources Policy Department

(1) Economic Benefits of an Oil Price Decline

Econometric studies generally agree that a decline in the price of oil would have a positive effect on our nation's economy by lowering inflation and interest rates and, thus, spuring economic growth and reducing unemployment.

Chamber economists examined the probable effects of an arbitrary $10 per barrel drop in oil prices. The results are listed in Table 1. Generally, they found it would provide the following benefits to the American economy:

A Drop in Oil Prices Raises GNP and Lowers Inflation. A sustained $10 per barrel drop in oil prices would raise the level of real GNP by 0.8 percent in the first year and 1.6 percent in the second year compared to what otherwise would have been the case. (See Figure 1.) In terms of growth rates, this means that a $10 per barrel decline in the price of oil would add 1.2 percentage points to real GNP growth in the first year and 1.0 percentage points in the second.

As a result of recent oil price decreases, we can expect real GNP to be 1.2 percentage points higher in 1986 and 1.0 percentage point higher in 1987 than would otherwise have been the case. Using the December 1985* Blue Chip consensus forecast of 2.5 percent growth in 1986 and 3.1 percent growth in 1987 as a starting point, this means that on the basis of the oil price decline that has already occurred, we can expect real GNP growth to be 3.7 percent this year and 4.1 percent in 1987.

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*The rationale for using the December 1985 consensus forecast rather than the latest one is that the former probably did not anticipate as rapid a decline in oil prices as has actually occurred.

The drop in oil prices would lower inflation. A $10 per barrel decline in oil prices would lower the rate of growth of the consumer price index by 1.1 percentage points in the first year. Any fall in oil prices is particularly good news to consumers as it cuts their energy bills.

Reduced Inflation Leads to Lower Interest Rates. Lower inflation rates are expected to lead to lower interest rates in 1986 and 1987. A $10 per barrel drop in oil prices should lower the rate on three-month Treasury bills by 30 basis points in 1986 and 20 basis points in 1987.

Lower Energy Costs and Lower Interest Rates Spur Investment. Lower energy costs and lower interest rates improve the outlook for both residential and nonresidential investment. A sustained $10 per barrel drop in oil prices should have the following effects: In 1986 and 1987, the level of nonresidential investment would be 1.3 percent and 3.0 percent higher, respectively, than otherwise would have been the case. Similarly, residential investment would be 2.1 percent higher in 1986 and 4.1 percent higher in 1987.

Increased Investment Creates More Jobs. Increased investment creates more private-sector jobs. As a result, civilian employment should be 0.4 percent higher in 1986 and 0.9 percent higher in 1987, than otherwise would have been the case. (See Figure 2.)

Lower Prices and Increased Employment Stimulate Consumer Spending. Lower prices and increased employment will raise real disposable income and consumer purchasing power. As a result, consumer spending will increase.

Chamber economists predict that the combination of stronger income growth and lower interest rates would reduce the budget deficit by a cumulative $20 billion over two years.

(2) Negative Effects on the Economy from an Oil Import Tax

Chamber economists also examined the economic impact of an oil import tax on the national economy. A simulation was performed by the consulting firm of Laurence H. Meyer & Associates (Table 2) based on an arbitrary $5 per barrel import tax. The static revenue increase from the tax is estimated to be $10.1 billion in 1986 and $10.8 billion in 1987. It is assumed that the Federal Reserve will realize that the rise in inflation is due to the import tax and not an upward trend in prices and, thus, provide additional reserves to maintain interest rates at approximately the same level as the base case. If the Federal Reserve did not accommodate the new tax, however, the negative effect on the economy, particularly on investment, would be larger.

The results of the simulation show that enactment of an import tax would lower overall economic activity and significantly increase inflation, partially offsetting the gains to the nation's economy stemming from the recent slide in oil prices. We believe these results offer compelling arguments against the imposition of an oil import tax.

An Oil Import Tax Lowers Real GNP, Increases Inflation and Lowers Consumer Spending. The level of real GNP would be 0.2 percent lower in 1986 (or $8 billion) and 0.5 percent lower in 1987 (or $17.3 billion) than otherwise would have been the case. This means that the rate of growth of real GNP would be 0.2 percentage points lower each year. (See Figure 3.) As a consequence of reduced economic activity and higher prices, real consumer spending would be 0.2 percent lower in 1986 (or $5.8 billion) and 0.4 percent lower in 1987 (or $10.5 billion) than otherwise would have been the case. Residential and nonresidential fixed investment would also suffer. Real nonresidential investment would fall 0.3 percent in 1986 (or $1.5 billion) and 0.7 percent in 1987 (or $3.7 billion). Real residential investment would fall by similar percentages.

Lower Investment Means Fewer Jobs Created. Lower investment means that fewer private-sector jobs are created. As a result, the oil import tax would cause civilian employment to fall by 0.1 percent and 0.3 percent in 1986 and 1987, respectively, compared to what would have been the case without the added tax. This implies a cumulative loss of 400,000 jobs in 1986 and 1987. The civilian unemployment rate would be 0.1 percentage point higher in 1986 and 0.2 percentage point higher in 1987. (See Figure 4.)

A new tax would reduce the size of the National Income Accounts (NIA) deficit. However, the dynamic reduction ($17.9 billion over the two years) is $3 billion less than the static revenue estimate ($20.9 billion over the two years). The deficit is not reduced as much as expected because lower levels of economic activity and higher unemployment raise federal expenditures and lower receipts. On the other hand, the increase in inflation that would result from the tax would offset part of the reduction in government receipts that would occur due to lower levels of economic activity.

(3) Additional Arguments Against an Oil Import Tax

In addition to the serious negative economic impact an oil import tax would have on the economy, an oil import tax should be opposed for the following important reasons:

--An oil import tax is not consistent with the U.S. policy of free trade. A sizeable portion of U.S. oil imports comes from neighbors and allies, such as Mexico, Canada, and the United Kingdom. A fee would harm them and might encourage retaliatory action.

--An oil import tax would lead to higher prices for all forms of energy: natural gas, coal, and electricity. The price of domestically produced oil would be bid up to the price of imported oil, including the fee, and the prices of other energy sources also would rise.

—An oil import tax would mean higher energy prices, which would increase domestic manufacturing costs, making it even more difficult for U.S. industries to compete overseas and at home. Foreign producers would retain their lower energy costs and be able to undercut American goods in the U.S. market. American exports would suffer and imports surge. Industries especially affected by an oil import tax would be basic metals, metalworking, machinery manufacturing, chemicals, agriculture, motor vehicles, and transportation.

--An oil import tax is regressive and would most severely penalize middle- and low-income consumers who spend a greater percentage of their income on transportation, food, utility bills, and other necessities.

—An oil import tax discriminates against regions of the country where automobiles are a necessity of life and where fuel oil is the prime source of home heating fuel.

—Foreign countries, some refiners, and certain consumer groups will undoubtedly seek exemptions from the tax. Such exemptions would lead to new bureaucratic entitlement programs that would offset much of the revenue the tax was supposed to raise.

—Consumers who suffered the skyrocketing energy prices during the 1970s as a result of excessive costs of cartel-controlled prices should not be required to support the price of domestic oil and indirectly other fuels for the benefit of a handful of those who benefited during the 1970s.

Conclusion

The Chamber believes that, while actions to protect the economy and national security against an overdependence on foreign-produced energy could warrant federal intervention in the marketplace, such intrusion is not warranted at this time and would be counterproductive to the economy. In addition, we believe that if and when a time arises that national security is threatened, an oil import fee would not be the appropriate solution.

Attempts to solve the budget deficit by requiring Americans to pay more taxes also are unwarranted. Instead, we urge Congress to work to reduce the growth in federal spending.

Table 1

ECONOMIC IMPACT OF A $10 PER BARREL DROP IN THE PRICE OF IMPORTED OIL

(Percentage difference from base unless otherwise indicated.)

	1986	1987
GNP	0.5	0.8
Real GNP	0.8	1.6
Consumption	0.8	1.4
Nonresidental Investment	1.3	3.0
Residential Investment	2.1	4.1
Civilian Employment	0.4	0.9
Consumer Prices (1)	-1.1	-0.3
Implicit GNP Deflator (1)	-0.4	-0.4
3-Month Treasury-Bill Rate (2)	-30.0	-20.0
Corporate Bond Rate (2)	-10.0	-20.0

Note: The base simulation is the current Laurence H. Meyer and Associates (LHM&A) forecast (BASE601). The price of OPEC oil is $20 per barrel in both 1986 and 1987. The alternative simulation assumes that OPEC oil averages $10 per barrel in both 1986 and 1987.

(1) Percentage point difference.
(2) Basis point difference.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University (LHM&A) model of the U.S. economy.

February, 1986

Table 2

ECONOMIC IMPACT OF A $5 PER BARREL OIL IMPORT FEE

(Percentage difference from base unless otherwise indicated.)

	1986	1987
Real GNP	-0.2	-0.5
Consumption	-0.2	-0.4
Nonresidental Investment	-0.3	-0.7
Residential Investment	-0.4	-0.7
Civilian Employment	-0.1	-0.3
Civilian Unemployment Rate (1)	+0.1	+0.2
Consumer Prices (1)	+0.6	+0.2
Implicit GNP Deflator (1)	+0.5	+0.2

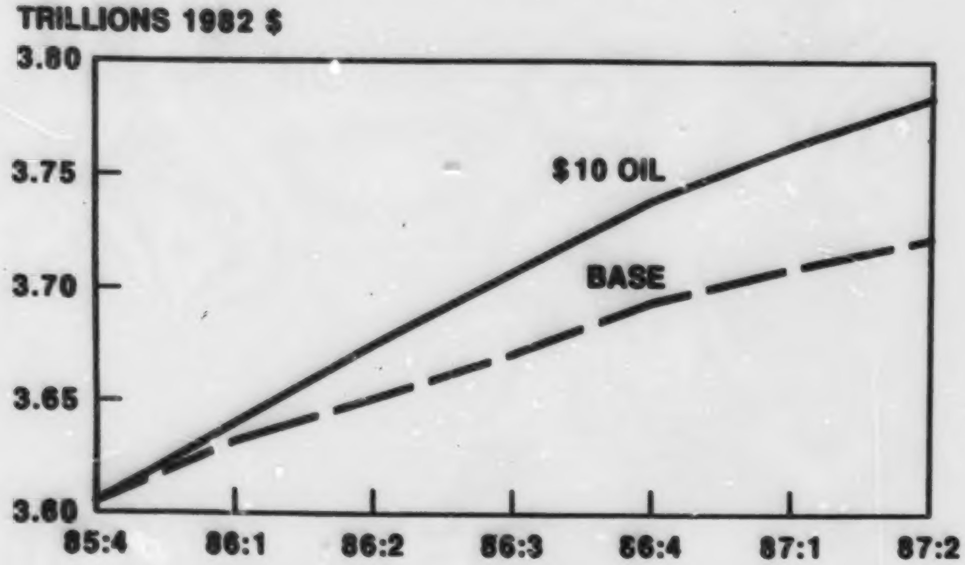
(1) Percentage point difference.

Source: Laurence H. Meyer and Associates, from a special analysis prepared for LHM&A clients.

February, 1986

Figure 1

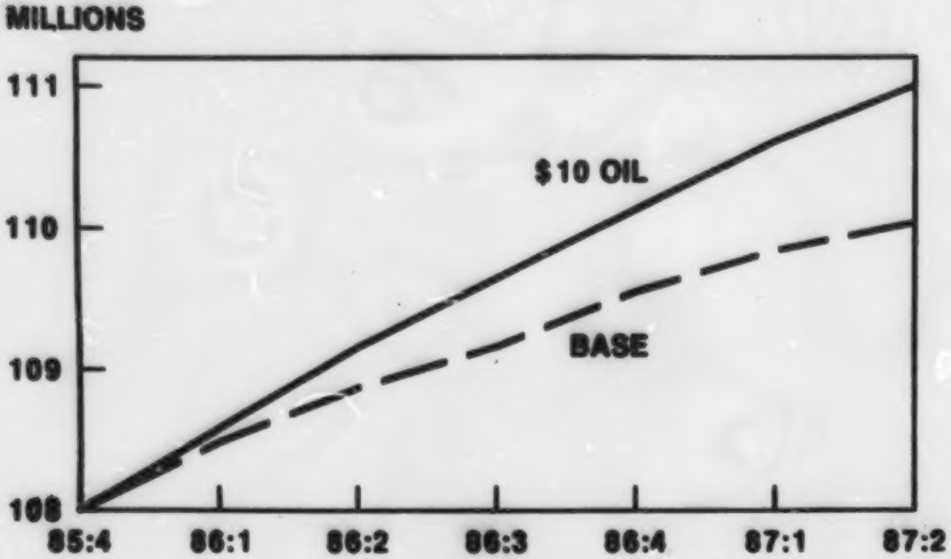
IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON REAL GNP



Source: U.S. Chamber of Commerce
February, 1986

Figure 2

IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON CIVILIAN EMPLOYMENT



Source: U.S. Chamber of Commerce
February, 1986

Figure 3

IMPACT OF A $5 PER BARREL IMPORT FEE ON GNP BILLIONS 82$

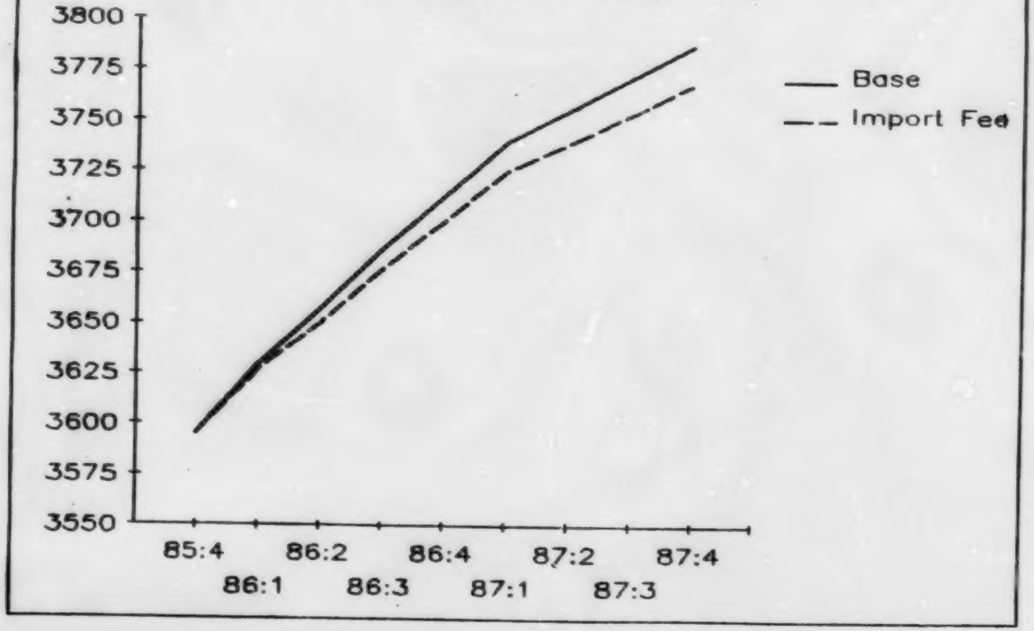
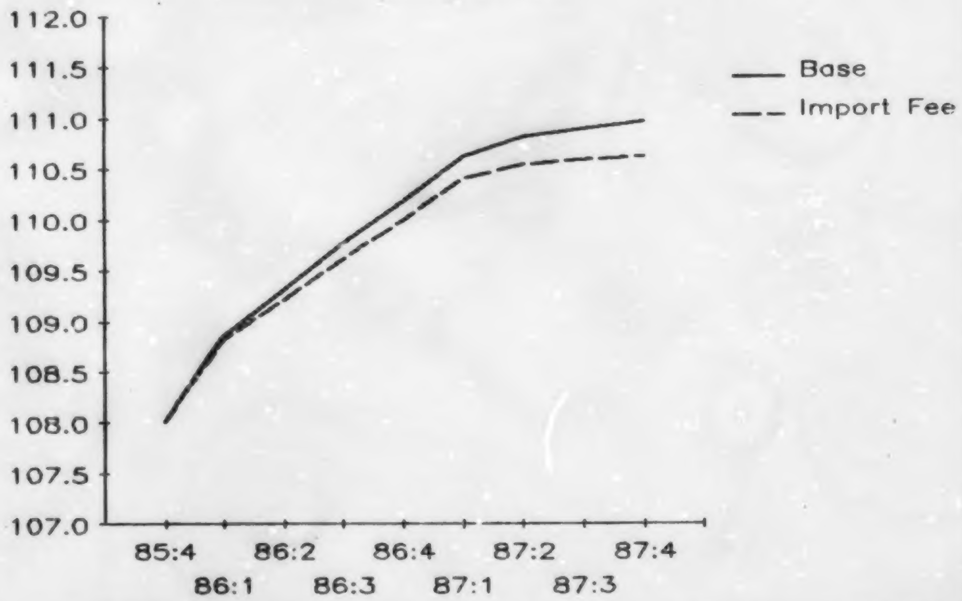


Figure 4

IMPACT OF A $5 PER BARREL IMPORT FEE ON EMPLOYMENT
MILLIONS



the **DOSCHERS GROUP** *inc*
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The Finance Committee of the U.S. Senate
SD-219, Dirksen Senate Office Building
Washington, D. C. 20510

Gentlemen:

In Re: A Tariff On Imported Crude Oil

A tariff on imported oil would not be in the interest of the people of the United States of America.

First consider the impact of oil prices on economic competitiveness. Japan purchases all of its crude from offshore suppliers; therefore the benefit it receives from lowered crude costs is not mitigated by any other factors. Hence, its cost of using energy and petrochemicals in manufacturing operations, space heating and cooling, and transportation will decrease.

A domestic tax on imported crude would raise the price of that crude to American consumers and American industry. It would be a foregone conclusion that American producers would raise the price of their product to that of the taxed foreign crude, and the overall result would be a disproportionately higher cost for energy in America than in Japan. All energy intensive goods made in Japan would be ever so much cheaper than the corresponding American made goods.

In addition, the American producers of crude oil would reap a great and undeserved profit by being able to raise the selling price of domestic crude. Since the American producers are not at this time reinvesting their profits in new ventures (other than to buy out other businesses) they do not merit any such windfall profit. American reserves would be pumped into pipe lines ever so much faster to make the quick buck.

Nothing less than a 100% windfall profits tax on crude oil sales would be fair to the hundreds of milllions of Americans who do not own stock in the oil companies.

A tax on crude oil can probably not reduce consumption any further without forcing another significant decrease in the standard of living of Americans. The asocial and vain rich who still demand inefficient automobiles constitute a small part of the population and the tax will not deter their vanity.

The ample supply and low price of crude oil are transient phenomena. It is caused at the moment by a fortuitous mix of two decades of deservedly high sales of efficient Japanese cars and lowered standards of living in North America and Western Europe, and peak sales of crude oil from Mexico and the North Sea. All this has resulted in a 50% reduction in crude oil sales for Saudi Arabia (from some 20 to 10 million barrels a day), and they are properly quite annoyed that the market has not been more fairly divided.

Being the strongest of all producers with a crude oil reserve of some 50 to 100 years (compared to less than 10 in the West) and an ability to produce more than any other nation, Saudi Arabia has fought back with its economic strength. It has lowered the price so as to punish marginal producers - (every other producer is marginal compared to Saudi Arabia except for the U.S.S.R.) even to putting some of them out of business.

The United States of America will no longer be a major oil producer within another decade. Domestic production will be less than 5 million barrels a day some ten years from now and heading lowere every day. The Saudis will let us know what the cost of a scarce commodity s at that time. If any tax on crude oil is being contemplated it should be one on domestic production - it should be conserved. However, the American economy - its oil producers, their employees and the dependent support and service population that it supports cannot take on such a burden at this time.

A supply of competitive and safe energy is America's Achilles heel. Extensive and probably expensive programs are as necessary, if not perhaps more so, for America's future than much of the space and defense budget. An energy policy that only looks at the short term and the quick buck will do us the greatest damage. Just consider the plight of the major oil companies on the west coast who rushed into co-generation, i.e., the use of natural gas to generate the steam for recovering their large resources of viscous crude oil. The price of crude oil is now so depressed that the cost of the co-generated steam is now moe expensive than that produced by burning natural gas. They are in a very bad bind by not being able to switch back to crude oil as the fuel for the steam generators. (It was heinous in the first place to use the limited supplies of so versatile resource as natural gas to to produce the viscous crude oil.)

A tax on imported crude oil would only further burden an already non-competitive American industry, singularly benefit the large oil companies, deprive the American consumer of a passing opportunity to increase his standard of living, and hasten the depletion of the nation's dwindling supply of gaseous fuels.

Sincerely yours,

Todd M. Doscher

(A career resume is attached for identification and to advise you of the expertise on which the foregoing comments have been based.)

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Todd M. Doscher

Dr. Todd M. Doscher is a registered professional engineer in Texas, California, and Alberta (Canada). He is President of the Doschers Group, Inc., engineering consultants, and Vice President of CLD Technology, Inc., an oil field service and research company.

Dr. Doscher took early retirement in 1976 as Head Office Consultant in Petroleum Engineering to Shell's Head Office Exploration and Production Division. He subsequently was appointed to the Pahlavi Chair of Petroleum Engineering at the University of Southern California and since 1982 he has devoted full time to consulting work.

Since 1976 Dr. Doscher has consulted for numerous private corporations and government agencies throughout the world. Among his industry clients have been Amoco Canada, Gary Energy, Winterschall, Brigitta, Union Texas, Marathon, General Atomics, Rocketdyne International, TRW, Sun Oil and Refining, TRV Minerals, Tosco, Superior Oil, Husky, Tenneco, and others.

The Doschers Group have been retained by government agencies in Mexico (Pemex), Venezuela (Intevep and Maraven), Iran (NIOC), Canada (Aostra), United States (Alaska, Central Intelligence Agency, U. S. Congress Office of Technological Assessment, Department of Energy), United Nations (Indian Institute of Reservoir Studies), and most recently visited the Peoples Republic of China under the auspices of the Institute for Nuclear Technology at Tsinghua University.

The principal area of expertise of the Doschers Group is in enhanced oil recovery, reservoir engineering, reserve studies and economic feasibility studies. However, their consulting work has also ranged from from developing optimum production plans for the Prudhoe Bay Oil Field (State of Alaska) to developing techniques for using solar steam generating technology for oil field applications (Department of Energy) to down hole steam generators (Rocketdyne) and evaluating the effect of nuclear detonations on cavity creation and heating in thick tar sand sections (Aostra).

Prior to being appointed as the Head Office Consultant, Dr. Doscher was Manager for Shell's Heavy Oil Project, and earlier had been Division Engineer for Shell Canada's Special Studies Project on the Athabasca Tar Sands. He was instrumental in the early research work and field development of steam technology for the in-situ recovery of heavy oils and bitumens. His earlier work with Shell included development of the membrane filter for determining the quality of subsurface injection fluids, development studies on drilling muds and fracture fluids, and chemicals for well stimulation and enhanced oil recovery.

Dr. Doscher was ultimately responsible at Shell for advice and consultation to the corporation on reservoir, petrophysical, and geological engineering and corresponding research activities and associated economic studies. In addition, he was responsible for Head Office technical activities and economic feasibility studies on unconventional sources of liquid and gaseous fuels; coal, oil shale and tar sands.

At the University of Southern California, Dr. Doscher developed courses in enhanced oil recovery and other profesional courses some of which were presented on interactive television throughout California and later in other parts of the world. He was Principal Investigator for the U. S. Department of Energy contracts at the University on physical modelling of the steam drive process, studies on carbon dioxide for the recovery of residual crude oil, and methane recovery from geopressured aquifers.

Dr. Doscher has been Chairman of the American Petroleum Institute's Committee on Recovery Efficiency, which awarded him a Certificate of Appreciation for his Chairmanship of the Committee on Recovery and Recovery Efficiency which recently issued a revised edition of its Bulletin D-14 on Statistical Correlation of Crude Oil Recovery, a Distinguished Lecturer of the Society of Petroleum Engineers, and an Editor of the SPE's Improved Oil Field Recovery Reports. He is Consulting Editor for McGraw Hill's Encyclopedia of Science and Technology.

Dr. Doscher has frequently contributed articles to the Journal of Petroleum Technology, The Journal of the Society of Petroleum Engineers, the Oil and Gas Journal, the American Scientist and other professional and trade journals. He holds several U. S. patents on oil recovery and oil field technology.

Prior to joining the petroleum industry, Dr. Doscher was employed in the food industry where he made significant contributions to the development of citrus pectens, soluble coffee and synthetic flavors. During World War II, Doscher was instructor in ESMWDT courses in New York, Ohio and California. Dr. Doscher graduated with a B.Ch.E., summa cum laude, from the City College of New York, an M.Ch.E. from Case Institute of Applied Science and his Ph.D. from the University of Southern California.

Dr. Doscher has been elected to membership in numerous honorary societies, including Sigma Xi, Tau Beta Pi, Phi Beta Kappa, and Phi Lambda Upsilon.

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Phillips Petroleum Co

Statement

of

John A. Clements

President

Highway Users Federation

to the

Senate Committee on Finance

Subcommittee on Energy and
Agricultural Taxation

hearing on

Oil Import Fees

S. 1997 and S. 1507

on

February 27, 1986

The Highway Users Federation (HUF) is a national, longstanding coalition of businesses, industries and associations working to make America's highway transportation systems safer and more efficient. Our 400 plus companies and business associations cut across 27 industrial and commercial categories, and are the chief users of highways and the main providers of highway transportation products and services. With affiliated highway user groups in every state, the Federation is the largest, most diversified organization of its kind in the nation.

We appreciate this opportunity to present the Federation's views on the oil import fee proposals (S.1997 and S.1507) before this Committee.

Because gasoline accounts for about 44 percent of petroleum use and the U.S. imports about 40 percent of the oil it consumes, a tax on imported oil would mean higher gasoline prices. The Federation estimates that a $10 per barrel oil import tax would boost the price of gasoline and other oil products by about 24 cents a gallon if it were fully passed through to consumers. It would add $143 annually to the cost of gasoline for the average motorist, and about $250 to the cost of heating the average oil-burner home.

Gasoline is already one of the most heavily taxed essential commodities in the country, averaging about 20 percent of the cost of the product. On top of the 9 cents per gallon federal tax, state taxes now range as high as 18 cents per gallon, with sales and local taxes adding even more to the price of a gallon in many parts of the country.

Highway users, regardless of income, do not have the option of shifting to other fuels and must use petroleum regardless of the cost. It is plainly unfair to make users of an already highly taxed product bear the brunt of the federal deficit.

Highway transportation has not contributed to the national deficit. The Transportation Trust Fund is required by Federal law to always have sufficient funds to cover expenditures. Our financial house is in order! The construction and maintenance of our nation's highways are financed by the users at the state and Federal level. At the Federal level in FFY '86 the highway program's spending from its dedicated source -- the Highway Trust Fund -- was reduced $3 billion. Deferring the expenditure of $3 billion of highway user generated funds is a significant contribution to a deficit the highway program in no way causes.

Taxing one essential commodity, like petroleum, for general government purposes is risky tax policy, especially when the product is targeted simply because its price is dropping.

In recent years, TV sets, computer chips, some items of wearing apparel, and other products have declined in price, according to the Bureau of Labor Statistics. Yet no one proposes that such products be special targets for new taxes simply because their price is declining.

Prices can and do go up as well as down. Tax policy based on fluctuating prices at any given time is bad policy and grossly unfair to the highway user.

Taxes for general public purposes should have the widest possible base and should fall equitably among all taxpayers. If an energy tax is necessary, then it should be fairly imposed on all energy sources. Petroleum should not be singled out. Why not increase the tax on natural gas, coal, hydropower and nuclear power?

An oil import fee does not provide this equity. There are major geographical inequities in an oil tax. Under such a tax, consumers in the West, who use more gasoline than the national average, would bear a disproportionate share of this financial burden. This tax will pit Westerners against Easterners and urbanities against rural and suburban dwellers.

Today's falling oil prices are contributing to America's economic resurgence. Less expensive oil will have a ripple effect throughout the economy, lowering fuel costs not only for transportation, but for manufacturing, farming, and such industries as plastics and chemicals. Lower oil prices help keep inflation down, boost individual buying power, and help create jobs by lowering business and industrial costs.

Artificially high oil prices have the opposite effect. A 1982 Congressional Budget Office study found that a $10 per barrel oil import tax would reduce the real Gross National Product (GNP) by 1.4 percent and industrial production by 3.3 percent, while increasing unemployment by one-half percent.

Current estimates are that a $10 per barrel oil import tax would reduce the GNP by at least one percent and increase unemployment by 300,000 to 400,000 the first year.

American manufacturers of petroleum-based products would bear a tax burden that foreign manufacturers don't. For example, in 1985, over 290 million tires were manufactured in the United States. Each passenger tire has about seven gallons of oil in its raw materials and its energy to produce. Having the tax on imported oil would raise the price of domestically produced tires with respect to imported tires, which could lead to further erosion of an important domestic manufacturing base and a continuing increase in unemployment.

Any additional tax on petroleum would have a direct and damaging effect on highway transportation. Since 1919 the tax on oil has been largely reserved for highways. Presently, motor fuel taxes at both the state and federal levels enjoy public support largely because they are clearly and correctly perceived as true user charges dedicated for the construction and upkeep of our nation's highway system. Additional petroleum taxes at the Federal level for non-highway purposes would preempt state and Federal taxing abilities for transportation's demonstrated needs.

An oil import fee could hurt the economy just at a time when today's falling oil prices are contributing to America's economic resurgence, and hurt the highway user community by imposing an inequitable share of the burden of deficit reduction on a segment of our society that has traditionally paid its way for the governmental services it has received.

In short, an oil import fee is a bad idea and it should not be foisted on the American public as an alternative to fiscally sound deficit reduction.

Thank you.

IPAC

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March 13, 1986

Senator Malcolm Wallop
Chairman
Subcommittee on Energy and Agricultural Taxation
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510
U.S.A.

RE: Oil Import Fee Legislation

Dear Mr. Chairman:

The two hundred producer members of the Independent Petroleum Association of Canada (IPAC) appreciate this opportunity to share with the Subcommittee our views on the possible imposition of a tax on imported crude and product. IPAC does not, as a normal practice, participate in the U.S. legislative process, and our submittal in this matter is made with the greatest deference and respect for your proceedings.

IPAC's members are in great sympathy with the stated objective of the Chairman to ensure energy "survival" through some measure of energy pricing stability. Like our counterparts in the United States, Canadian independents drill the vast majority of new wells. More importantly, our members, like U.S. independents, are most affected when prices plunge and cash flow falters. In the current climate bankruptcies are a certainty, exploration activity has all but ceased, and the only open question is not whether, but the degree to which our industry will be permanently injured as a result of the market manipulations of OPEC nations.

Our interest in the Subcommittee's deliberation over an oil import tax should be readily apparent — Canada is now the second largest source of U.S. crude imports, representing approximately 15 percent of total U.S. crude imports at an average of 500,000 barrels per day. In addition, Canada supplies approximately 100,000 barrels per day of refined petroleum products to the U.S. market.

Canada's role in enhancing America's energy security is not an accident — but the result of years of effort to achieve an equitable and mutually beneficial energy trading relationship. The uniqueness of this relationship is exemplified by the fact that Canada is the only foreign petroleum supplier to the United States that is has pipeline connected. Since 1983, Canada's role as a supplier of crude to the U.S. market has nearly doubled. This has contributed significantly to the United States's ability to wean itself from its previous dependence on OPEC crude sources. In this context, Canadian supplies can now be viewed as augmenting the Strategic Petroleum Reserve but at no cost to the American taxpayer.

Furthermore, Canadian policies which had been antagonistic to American investment have now been discarded and replaced with policies which actively encourage long-term cooperative, commercial relationships. Our Association has been at the forefront in promoting and creating this positive and constructive relationship.

IPAC has reviewed the possible impact and implications of the United States imposing an oil import fee or tax. Our conclusion is that the imposition of an import fee or tax, in the absence of an exemption, would (1) have a serious detrimental impact on the Canadian oil industry; (2) be inconsistent with and contrary to the commitment of President Reagan and Prime Minister Mulroney to reduce energy trade barriers between our two countries; and (3) increase, rather than reduce, American dependence on OPEC oil. We believe this last point is critical — both for us and for your deliberations. Our initial analysis is in accord with the testimony of Deputy Secretary Boggs, who stated that "the fee would likely affect high cost producers more than low cost producers. Since most of our imports now come from Canada and Mexico, the fee is likely to reduce imports from non-OPEC nations rather than reducing OPEC sales".

IPAC respectfully suggests that an oil import fee would only achieve the goals of energy "survivability" and security if there is a "North America" exemption. IPAC submits that exempting Canada and Mexico would enhance rather than diminish U.S. energy security by preserving and protecting North America's energy production capabilities — one of the basic precepts of a North American energy policy. For example, current low international oil prices have already eliminated much of the attractiveness of developing Canada's frontier resources, and the imposition of a U.S. import fee would further curtail development of this significant resource.

We recognize, as others have pointed out, that once the exemption process starts, it is difficult to know where to draw the line. However, in Canada's case, there is strong precedent for an exemption, Canada was exempt from the mandatory oil import quotas in effect from 1959 through 1973. Nonetheless, even if exemptions were provided for Venezuela and the United Kingdom as well, the principal objectives of the Subcommittee — survivability and security — would still be met, while only the objective of raising revenue would be reduced, but not eliminated.

IPAC thanks the Subcommittee for giving us the opportunity to express our views on this critical issue.

Sincerely,

INDEPENDENT PETROLEUM ASSOCIATION OF CANADA

A.R. Price
Chairman

cc: Senate Finance Committee Members

THE EFFECTS OF PROPOSED TAX REFORM ON THE INTERNATIONAL COMPETITIVENESS OF U.S. INDUSTRIES

TESTIMONY PRESENTED

to

THE INTERNATIONAL TRADE COMMISSION

OF THE UNITED STATES

by

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(IRET)

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* The views expressed here are my own and do not necessarily reflect the views of IRET or its contributors.

Summary

o On balance, both the Administration's tax reform proposal and the tax reform bill passed by the House of Representatives pose a serious threat to future U.S. competitiveness.

o The reduction in marginal tax rates under the individual income tax would improve U.S. competitiveness. It would result in

- o an increase in the supply of labor services,
- o an increase in the after-tax return to productive effort,
- o a moderation in the rate of increase of future unit labor costs,
- o a reduction in the income tax bias away from personal saving, thereby increasing the supply of national saving available for capital formation.

o The positive aspects of tax reform on the individual side are overwhelmed by many of the base broadening proposals for the corporate income tax.

o One of the greatest threats to future U.S. competitiveness of the tax reform proposals is the repeal of the ITC and the replacement of ACRS with either the CCRS or IDS.

o Each tax reform proposal contains numerous other policy-poor revenue-raisers on the corporate side, including

- o the Alternative Minimum Tax, definitionally a bankrupt idea in terms of tax policy,
- o the reduction in the Incremental Research Tax Credit,
- o the reduction in the exclusion rate for Foreign Sales Corporation (FSC) income.

Taken together, these measures would result in a significant reduction in the ability of U.S. firms to compete internationally.

o Congress should retain the positive elements on the individual tax side and jettison the policy-poor revenue raisers mentioned above in favor of the competitiveness enhancing Business Transfer Tax or some variation thereof.

The Effects Of Proposed Tax Reform On The International Competitiveness Of U.S. Industries

My name is J.D. Foster. I am an economist with the Institute for Research on the Economics of Taxation (IRET). IRET is a non-profit, non-partisan, tax and fiscal policy research organization. Our focus at IRET is to analyze the effects of taxes on individuals' incentives to work, save and consume. From this perspective we are able to examine the effects of various tax systems and tax proposals on the prospects for economic growth and U.S. international competitiveness.

It is encouraging to see U.S. competitiveness being given greater consideration in the tax reform process. I commend the International Trade Commission and the Senate Finance Committee for recognizing the importance of taxation for future U.S. competitiveness and for holding this hearing to improve the awareness of all of us as to the ramifications of the various tax reform proposals.

The U.S. international trade deficit, and the U.S. international trade position in general is the result of many forces great and small, not all of which are affected by U.S. tax policy. Nonetheless, where tax policy, and the final product of tax reform, does have an impact, that impact is often great.

In the large, the manner in which tax reform can affect U.S. international competitiveness is through its effects on saving, investment, and the productive effort of the American people. In the large, neither the current tax system, nor the tax reform of the President's proposal, nor the bill passed by the House of Representatives gets better than a mixed report card.

The Current Structure of Tax Reform

In rough outline, both the President's proposal and that of the House reduce the individual income tax by lowering marginal tax rates. In the case of the President's proposal, the top rate for individuals is reduced to 35%, while under the House proposal the top rate is set at 38%. Similarly, the top rate for corporations is slated to fall to 33% and to 36%, respectively. To compensate for the revenues lost due to rate reduction, the tax base for individuals is to be broadened somewhat, and the tax base for corporations is to be broadened substantially. Furthermore, the minimum tax for both individuals and corporations in the House Bill is raised substantially as a short-cut to curtailing perceived tax abuses, raising significant new revenues without directly addressing the provisions responsible for the abuses. The effect of both reform measures is to shift from a direct income tax burden on individuals to an indirect tax on individuals by way of the corporate income tax.

To determine the net effect of tax reform on U.S. competitiveness, we must ask whether the shift of the tax burden from individuals to individuals via corporations improves or impairs economic efficiency and the allocation of resources. Expressed another way, is this indirect taxation more or less distortionary to the decisions taxpayers make with respect to consumption, saving, investment and work than direct taxation?

The correct approach to answer this question is to consider how the tax burden is shifted under each reform proposal and whether, as a result of the shift, the distortionary effects inherent in an income tax are reduced on the individual side sufficiently to compensate for the increased distortionary effects on the corporate side. If the answer to the question is negative for either proposal, and I believe both proposals represent a net increase in the distortions the tax system imposes on the economy, then that proposal represents a step backwards over current law and would be very detrimental to economic efficiency and U.S. competitiveness.

The prospects for reducing the distortions on the individual side are relatively straightforward because, except for some base broadening and a stiffer minimum tax, tax reform can be summarized by the phrase "marginal rate reduction." The corporate side is much more difficult, however, because along with rate reduction we have a number of measures proposed to broaden the corporate tax base. These base broadening measures are the primary revenue-raisers that allow each tax reform proposal to be "revenue neutral." Therefore, the prospects for increasing the distortions (and their effects on U.S. competitiveness) on the corporate side are wound up in the question of whether either reform proposal would result in a more accurate definition of taxable corporate income than current law. A simple example will suffice to show why correctly defining taxable income is at the crux of the matter.

Suppose that at current factor and product prices a corporation employs two factors of production, A and B, in equal proportions, and suppose for simplicity that each has a cost per unit of production equal to one in a world without taxes. This is the most efficient arrangement available to the corporation because it reflects the true costs to the economy of using factor inputs. Now suppose a corporate income tax system is imposed under which the costs of employing A in the production process is fully deductible against corporate income, whereas the costs of employing B may never be deducted. Under such a system, the tax base for this corporation includes profits, if any, plus the costs of purchasing B as an input factor. That is, a cost of doing business is being taxed as well as profit.

The effect of the corporate income tax on the corporation is clear in this case. The cost of employing B in the production process increases dramatically, relative to the cost of employing A. The firm responds to this new cost structure by reducing its use of B and compensating by using more A wherever possible. This is necessarily a less efficient arrangement than that before the tax was imposed. The net result is a less efficient allocation of resources, higher costs, higher prices or reduced output levels, and a loss of competitiveness of the firm in question as well as any other firm that relies on the products of the subject firm.

The question on the corporate side, then, is whether the corporate tax base-broadening measures included in the tax reform proposals reflect a movement towards more or less accurate accounting for the expenses of corporations. If less, then the distortions produced by the corporate income tax will be increased under the reform proposals. The loss of competitiveness on the corporate side must then be compared with the gains, if any, on the individual side, to determine whether either tax reform proposal improves the ability of U.S. firms to compete with foreign firms at home and abroad.

Individual Rate Reduction And The Cost And Supply Of Labor

The reduction in the statutory marginal tax rates faced by individuals, assuming these reductions are reflected in corresponding reductions in effective marginal rates -- a matter about which there is some debate -- is a positive step for U.S. competitiveness. For one thing, lower rates will result in an increase in productive effort supplied at any market wage rate. Beyond some minimum level of income, individuals face a choice between using their time for leisure activities or for supplying labor services. How much labor they supply depends on the real after-tax wage they can claim. For a given wage level, a reduction in the marginal tax rate translates directly into an increase in real after-tax wage, and, therefore, an increase in the amount of time and effort an individual is willing to offer to those who demand his services.

At a given nominal wage, a reduction in the individual marginal tax rate means that the after-tax wage received by the worker increases. Consequently, U.S. firms will likely see a moderation in the rate of increase in the wages they must provide in order to employ the same amount and quality of labor services. That is, there is likely to be some sharing between firms and workers of the benefits of the marginal rate reduction resulting in a net increase in supplied labor services, a net increase in after-tax wages earned by workers, and a net decrease in unit labor costs faced by U.S. firms competing at home and abroad. For lack of a better name we can call this array of consequences the labor-supply effect of a reduction in the marginal tax rate facing individuals.

This labor-supply effect has at least three implications for U.S. competitiveness. By increasing the supply of labor services available for production, a reduction in the marginal tax rate provides at least one force for increasing the rate of growth of long-run real domestic output. An increase in real output translates into an increased capacity to export goods and services. Therefore, a rate reduction would result in a long-run increase in the export capacity of the U.S.

A second implication of the labor-supply effect is the likely moderation in the rate of growth of real wages paid by U.S. firms. Examined in isolation from the rest of tax reform, such a moderation would imply a reduction in the unit labor cost of production relative to the unit costs of all other factors of production, such as capital and energy. In the short-run this will undoubtedly be a helpful force for improving U.S. competitiveness. In the long-run, however, as firms adjust to the new relative prices, firms that use labor intensively in their production processes relative to other factors will continue to have gained a competitive edge relative to their foreign competitors. However, this gain would come at the expense of firms that use other factor inputs intensively relative to labor. Therefore, in this respect, the labor-supply effect results in a shifting of competitiveness among different categories of U.S. producers and would result in a net increase in U.S. competitiveness only to the extent that the U.S. has a natural advantage in labor-intensive activities that has been heretofore stifled through the tax code. As we shall show below, U.S. exports have been historically dominated by capital-intensive and high-technology goods; in itself, this effect of individual rate reductions is likely to afford only modest gains in U.S. competitiveness in the long-run.

The third implication of the labor-supply effect is that, as the marginal rate is reduced, the wages that firms actually pay and the after-tax wages individuals receive converge. As a result of the reduction of this tax wedge, the amount of labor services demanded and supplied will tend to conform more closely to what would be the case in a world without taxes. It follows, then, that labor, and all other factor inputs, will be put to more efficient uses. This increase in efficiency translates directly into a reduction in production costs of all firms, whether they currently use a heavy labor input or not. Therefore, this tax wedge side of the labor-supply effect will be a positive force in improving U.S. international competitiveness.

Individual Rate Reduction And Individual Saving

The reduction in individual marginal tax rates has a further, highly beneficial effect on U.S. international competitiveness. The U.S. personal income tax system defines the tax base to include income that is saved and and income from previous saving. Consequently, a particular flow of income devoted to saving is taxed repeatedly whereas income devoted to consumption is taxed but once. This obviously imposes a tax bias against saving in favor of consumption, and contributes significantly to the historically low levels of personal saving in the U.S. By reducing marginal tax rates, tax reform promises to reduce the income tax bias against saving, and to result in a greater stock of national savings available for investment.

The significance for U.S. competitiveness of the tax-dampened personal saving rate is an often mentioned yet rarely explained proposition. By reducing the rate of personal saving, the income tax reduces the amount of saving available for investment. Consequently, less capital formation takes place, and that which does occur must yield a higher real rate of return. This increase in the cost of capital over what would be the case in the absence of taxes reflects a diminished national capital base, and is reflected in a loss of competitiveness insofar as the U.S. competitive position hinges on the provision of an extensive capital base.

Tax Reform On The Corporate Side

The reduction in the individual income tax burden under both reform proposals is to be paid for by increasing U.S. corporate income taxes, effectively shifting immediate tax burden from individuals to corporations. Since corporations don't pay taxes, only collect them from factor inputs and the consumers of their products, the effect of tax reform as presently conceived is to reduce one anti-competitive tax and raise another. One should not be led to believe however, that the effects of such a shift would cancel each other out.

Firms that compete in export markets or compete with imports in the U.S. face prices set on the world market. If the prices an internationally competing U.S. producer must charge to maintain a minimum level of profitability are driven up by an increase in its tax burden, that producer will find his prices under-cut by foreign producers, unless, by some chance, foreign governments raise the tax burden facing the firms the U.S. competes with, or the real dollar exchange rate decreases to compensate for the increase in U.S. prices. Theoretically, the latter should occur, at least in the long-run, though the turbulence in todays exchange markets makes it unlikely one would ever be able to check this. It is safer to assume, therefore, that the U.S. producer has virtually no ability to pass any increased tax burden onto consumers through higher prices.

Unable to pass the increased tax burden onto their customers, U.S. firms would have to pass the tax burden onto their factor inputs by reducing the amount of these inputs the firm is willing to buy at any given price. The precise manner in which the burden would be shifted depends on a great many factors. One such factor would be how the elements of tax reform on the individual side affect the real, after-tax returns to work, consumption and saving. In discussing the individual rate reductions we found that reducing individual tax rates would result in an increase in the after-tax return to working, a gain to individuals that likely would be shared with firms in the form of lower real pre-tax wages. Furthermore, lower rates on individuals would reduce the tax on savings, so that individuals would accept a lower real pre-tax return on their savings to maintain the same level of saving. Therefore, the rate reductions on the individual side do leave U.S. firms some latitude to pass the increased corporate tax burden onto factor inputs, in this case capital and labor, without requiring that these factors accept a lower after-tax return. Insofar as corporations do pass the tax increase back to these production inputs, the beneficial effects of individual rate cuts are canceled.

Thus far we have talked about the amount of tax burden that would be shifted. A second factor to consider is the manner in which the corporate income tax burden is increased. The choice of base-broadening measures for the corporate income tax will have a major impact on determining who will pay the tax, for, as the example above showed, improperly defining taxable income has a significant impact on relative input costs and, therefore, on how corporations arrange their production processes.

Anticipating the discussion to follow, much of the corporate tax base broadening results from proposals to revise the present capital recovery system in a way that would result in increasing the real cost of capital. This means that much of the tax burden is to be shifted onto the product of future capital formation, thereby reducing the level of future capital formation. The shift in the tax burden would result therefore, in a long term and permanent reduction in the capital stock of the nation. Consequently, as currently conceived, the increased tax burden on internationally competing firms would result in a loss of competitiveness for the nation, as well as a long term reduction in real wealth, real wages and a contraction of real output.

The Impact On Investment

Many of the provisions of the President's and the House's tax reform proposals strongly influence the likely amount and composition of future private capital formation. In fact, one of the main revenue raisers in both tax reform proposals is the repeal of the Investment Tax Credit (ITC), and the replacement of the Accelerated Cost Recovery System (ACRS) with the Capital Cost Recovery System (CCRS) under the President's proposal, or the

Incentive Depreciation System (IDS) under the House proposal. Under both CCRS and IDS, a major step backward has been proposed in the evolution of U.S. tax policy. The result of either plan would be a reduction in the level and a distortion in the composition of capital formation and severe consequences for U.S. competitiveness.

U.S. international competitiveness can be bolstered effectively if tax reform results in a tax system that is consistent with economic efficiency. That is, the resulting system must be as neutral with respect to prices and costs as possible. To conform with tax neutrality, taxes must leave unchanged the costs of acquiring and holding capital relative to the cost of consumption. This requires a lot of a tax system, especially one that includes a corporate income tax. One element that is absolutely essential is that capital outlays are properly accounted for in computing taxable income. This can be accomplished in one of two ways. The best way is to allow the expensing of capital outlays. Expensing would accord capital costs the same treatment as any other cost of doing businesses. If, however, capital recovery allowances are to extend over a period of years, then neutrality can be achieved if the present value of the allowances for each asset is equal to the cost of that asset. Neutrality is maintained under such a multi-period system because the total allowances for each asset are the present value equivalent of expensing.

There is nothing sacred about having an investment tax credit; nor is the ACRS, in fact, an optimal way of resolving the capital recovery issue. Together, however, they result in tax treatment of capital expenditures that comes as close as the corporate income tax ever has to insuring that the present value of the combined capital recovery allowances equals the cost of the asset purchased. As indicated in Table I, at a 5% inflation rate and a 4% real after-tax discount rate, the combination of ACRS and ITC result in a present value of allowances per dollar of investment that approaches unity for many property classes. Comparing this result with CCRS and IDS shows that each of the proposed alternatives yields to the firm a present value of allowances far short of the cost of the asset.

A further consequence of adopting CCRS, IDS, or some other regressive capital recovery system would be to create an additional incentive to move production to foreign locations in which capital is taxed more lightly. It is a common mistake to assume one can increase the cost of capital through taxation without suffering a shift in global capital formation away from the taxing country. Capital is a highly mobile commodity, well able to move to locations where it is well-treated.

These results can be given an alternative interpretation which serves to provide some intuition on the meaning of an improper capital recovery system. In Table 2, the effective tax rates on investment are presented for each of the three recovery systems under consideration at various rates of inflation. The rates reflect, in a sense, the effective tax rates borne by the investment outlay itself, rather than the income resulting from that outlay. As the table indicates, CCRS and IDS each raise the cost of investing in shorter-term assets relative to ACRS-ITC, while maintaining a significant cost increase for longer term assets. Consequently, CCRS and IDS represent an increase in the effective rate of taxation of capital outlays.

The conclusion to be drawn is that, while the ACRS-ITC currently in use is not perfect, for many classes of assets the CCRS and IDS proposals significantly worsen prospects for capital formation by increasing the costs of capital.

To see the effect these proposals would have on competitiveness, consider the composition of U.S. exports and imports. In 1984, machinery and transport equipment, manufactured goods and chemicals, all highly capital intensive operations, represented over 60% of U.S. merchandise exports and 55% of merchandise imports. Similarly, these goods represented 33% of all exports of goods and services and over 40% of all such imports. Raising the cost of capital to these firms would reduce their profitability and their ability to make the necessary capital outlays to remain competitive. Such a policy would constitute a direct threat to the international competitiveness of the major exporting and import-competing sectors of the U.S. economy. It is curious that the outcry over increasing investment and international competitiveness in the U.S. should be forgotten so quickly in the rush to raise revenue via the corporate income tax.

The Minimum Tax

The minimum tax was originally intended to ensure that individuals and corporations who paid little or no regular income tax due to "tax shelters" would pay some tax. In the case of corporations, these "tax shelters", or, more accurately, tax preferences, were each intended to create an incentive to perform some activity. The operations of some corporations allow them to pay little or no current income tax, although they may be incurring tremendous amounts of future tax liabilities. Rather than examining these preferences individually to see if they are good tax policy, and rather than limiting directly their availability to corporations that are able to use so many of these preferences that they have little tax liability left, the corporate minimum tax was enacted to limit their use indirectly. To the extent that a corporation pays a minimum tax, the value of the preferences claimed under the regular corporate income tax is reduced as is the incentive effect the preference was intended to produce.

Current law allows an add-on minimum tax under which various deductions allowed in the computation of corporate taxable income are determined to be preferences. As such they are summed to

Table 1*

Present Value Of Cost Recovery Allowances Per Dollar of Capital Asset Under ACRS-ITC, CCRS, And IDS At Selected Inflation Rates

Property Class

			Inflation = 2%			Inflation = 5%			Inflation = 10%		
ACRS	CCRS	IDS	ACRS -ITC	CCRS	IDS	ACRS -ITC	CCRS	IDS	ACRS -ITC	CCRS	IDS
3 yr	1	1	1.01	0.92	0.92	0.97	0.91	0.88	0.91	0.89	0.84
		2			0.88			0.82			0.78
		3			0.84			0.77			0.72
		4			0.78			0.70			0.64
5 yr	2	5	1.03	0.91	0.74	0.97	0.90	0.65	0.84	0.80	0.58
	3	6		0.39	0.70		0.88	0.60		0.86	0.53
10 yr	5	7	0.94	0.83	0.64	0.85	0.82	0.54	0.74	0.80	0.47
		8			0.59			0.48			0.41
18 yr	6	10	0.65	0.59	0.46	0.55	0.60	0.34	0.43	0.60	0.27

Table 2*

Effective Tax Rates Under ACRS-ITC, CCRS and IDS At Selected Inflation Rates

Property Class

			Inflation = 2%			Inflation = 5%			Inflation = 10%		
ACRS	CCRS	IDS	ACRS -ITC	CCRS	IDS	ACRS -ITC	CCRS	IDS	ACRS -ITC	CCRS	IDS
3 yr	1	1	-.8	3.7	4.6	2.7	4.4	6.7	8.0	5.4	8.8
		2			7.0			9.9			12.5
		3			9.2			12.8			15.8
		4			12.1			16.6			20.1
5 yr	2	5	-2.43	4.3	14.8	2.7	5.0	19.9	9.9	6.0	23.6
	3	6		5.3	17.2		5.9	22.8		6.9	26.5
10 yr	5	7	5.3	8.5	20.1	12.7	9.1	26.0	22.2	10.0	29.7
		8			23.1			29.3			33.0
18 yr	6	10	29.6	20.1	30.6	38.7	20.5	37.3	49.0	21.2	40.8

Note: There is no clear, simple way to compare and present the asset classification schemes among the three systems. The pairing of asset classes presented here is approximate and should not be used for a rigorous analysis of the relative treatment of a particular asset under each system. Class 4 under CCRS and Class 9 under IDS were excluded because each refers to long-lived, non-business use property.

* Michael A. Schuyler and Carlos E. Bonilla provided the calculations shown in Tables 1 and 2, and deserve the credit for this important contribution to this testimony.

form the minimum tax base. The current add-on minimum tax rate is 15% of the minimum tax base and represents a tax liability to the extent it exceeds the regular corporate income tax liability. Both the President's and the House's tax reform proposals replace the add-on minimum corporate tax with an alternative minimum tax (AMT).

Under the AMT, the number and amount of income tax deductions that are defined as preferences would be increased and then added to regular taxable income to form the AMT base. Under the President's plan a tax rate of 20% is adopted, while the House plan employs a 25% tax rate. The increase in corporate tax liability due to the AMT liability is the excess, if any, of the AMT base times the AMT rate over the regular income tax liability. Furthermore, incentive credits such as the Incremental R & E Tax Credit may not be used to reduce the AMT liability.

Any minimum tax, the AMT in particular, raises some difficult conceptual questions. Within the framework of tax reform in which the corporate income tax rate is reduced to 35 or 38%, an AMT rate of 25% would put a large number of taxpayers on the AMT on, essentially, a permanent basis. This would be the case, in particular, for timber producers, utilities, and those heavily-capital intensive manufacturing companies at the forefront of competition for markets at home and abroad. So-called high-tech companies might also find themselves subject to the AMT much of the time because the expensing of Research and Experimentation costs (to be discussed below) is considered a preference and must be amortized over 10 years. Furthermore, because the AMT liability cannot be offset by most incentive credits, for companies on the AMT on a more-or-less permanent basis, these credits are lost or are of greatly diminished value.

There are numerous other proposals that have little or no justification in theory, that will be highly detrimental to the international competitiveness of the U.S., and whose sole purpose is obviously to raise revenue on a few-billion here, few-billion there basis.

Research And Development

The development and application of new technology is widely recognized as being of fundamental importance to the future of America's competitiveness as well her general economic growth. Through new technology new products and new production processes are developed. New technology stimulates capital formation by promising increases in productivity and improvements in the quality of output. New technology and capital formation hold the key to continued growth in real wages and real wealth. Ultimately, the products of innovation, including increased capital formation and improved productivity, hold the key to improving the U.S. competitiveness.

The tax system can have a profound effect on the level of research and development (R & D) outlays. If such outlays are treated in full as normal costs of doing business, then the tax system provides no more bias in favor or against R & D than any other corporate activity. The tax system can be a substantial impediment to research if such outlays are subject to a capital recovery system that falls short of the present value equivalentof expensing. On the other hand, increased R & D expenditures can be promoted by allowing additional tax credits or deductions for R & D activity; this has been the intent if not the effect of recent tax policy in recent years in recognition of the importance of technology to economic growth and competitiveness.

On the positive side, current law allows the taxpayer to deduct currently research and development outlays with a useful life not extending beyond the current year. On the negative side, expenditures with a useful life extending beyond the current year must be capitalized, that is deducted piecemeal over a number of years according to the capital recovery system in place at the time. Therefore, capitalized research outlays are subject to the same non-neutral, restrictive treatment as other capital expenditures under our current system.

Current law also allows for an Incremental Research Tax Credit (commonly known, and hereafter referred to, as the R & D Tax Credit) of 25% for qualified research expenditures in excess of the average of such expenditures over the previous years. There are a number of shortcomings with respect to the structure of the credit. One important short-coming is that it is unavailable to start-up firms by the very fact that they haven't had three years of previous expenditures.

Another short-coming is that the credit has been on a temporary footing since its adoption in 1981. By their very nature research activities face a very uncertain pay-off. To help minimize this uncertainty and get the greatest return per dollar invested, considerable planning goes into defining the research program that guides research expenditure. Such a program is not likely to be influenced much by a tax credit that may not be available by the time the program is well-underway. Certainly the recent expiration of the credit is unlikely to improve its effectiveness. The credit must be made permanent for it to achieve its full effect.

Perhaps the most important short-coming of the R & D tax credit is that "qualified expenditures" include primarily R & D outlays which are expensable, but does not include tangible property subject to the ACRS depreciation allowance system. Current law, therefore, provides a most peculiar tax arrangement for R & D expenditures. Wages and non-depreciable supplies are (quite properly) expensed, and may be eligible for the R & D tax credit as well, thereby lowering their relative, after-tax real costs below what would be the case in a world without an income tax.

Equipment and structures purchases, however, must be depreciated and are eligible for the lower rate Investment Tax Credit. As we found in the discussion on investment above, the combination of ACRS-ITC falls short of expensing-equivalency for many combinations of assets and inflation rates. Consequently, the real relative costs of R & D expenditures on depreciable property exceed what would be the case in an income tax-less world.

While imperfect, current tax law does avoid severely hampering most research activities, although it provides a strong bias towards outlays other than for equipment and structures. The President's proposal is a definite step backwards from current law because of the repeal of the ITC and the replacement of ACRS with CCRS capital recovery system, which would provide significantly worse treatment for capitalized R & D expenditures. The House proposal would weaken the tax incentives for R & D even further. For one thing, along with the repeal of the ITC, the House proposal replaces the ACRS with the IDS, which, as noted, above, is a serious step away from the neutral tax treatment of investment. For another thing, whereas the President's proposal essentially left the R & D tax credit alone, the House proposal would reduce the credit from 25% to 20%.

The effect of these proposals on the costs of R & D expenditures can be seen from Table 2. As with general investment expenditures, R & E expenditures ought to be expensed. To the extent that the present value of allowances is less than the equivalent of expensing, the corporate income tax is, in effect, taxing the R & E expenditure. Table 2 presents the rate at which they would be taxed under either the President's or the Houses tax reform proposals. It is clear that, for most outlays, both reform proposals would severely raise the real, after-tax costs of R & E, and would reduce the amount of these expenditures. There can be little question that this would constitute a severe blow to U.S. competitiveness.

The Foreign Sales Corporation

A second example of anti-competitive revenue-raising in the House proposal arises in the treatment of Foreign Sales Corporation (FSC) income. Created to promote the export of U.S. manufactures by lifting some of the U.S. corporate tax burden from U.S. exports, the FSC rules allow U.S. exporting corporations to route the income from foreign sales of U.S. manufactured goods through a foreign office and thereby exempt a portion of that income from the U.S. corporate income tax. The FSC rules are becoming increasingly important in promoting U.S. exports, particularly when U.S. goods compete with goods from countries, e.g. France, and the United Kingdom, where a Value-Added Tax (VAT) is employed because, under a VAT, the tax burden on their exported goods is rebated to the manufacturer. Therefore, whereas U.S. businesses bear the U.S. tax when competing in a third country, French goods bear little or no federal tax.

Under current law, and under the President's proposal, when export income qualifies for FSC treatment, 16% of that income is exempt from the U.S. corporate income tax. Under the House proposal however, only 14% of the same income would be exempt from the tax. If enacted, this proposal would lower the profitability of U.S. production devoted to exports, thereby reducing the incentive to export. This would be a negative step in maintaining and improving the U.S. competitive position.

Concluding Remarks

The President's tax reform proposal, and that passed by the House of Representatives both contain elements conducive to improving future U.S. international competitiveness. Each proposal also includes powerfully anti-competitive elements, including the replacement of ACRS with badly defective alternatives, the repeal of the ITC, and the policy-poor Alternative Minimum Tax. On balance, both reform proposals represent a serious threat to U.S. international competitiveness.

It is unfortunate that an otherwise positive, pro-growth, pro-competitive effort at reforming U.S. tax policy should be dashed on the shoals of powerful, anti-competitive revenue raisers such as the CCRS or IDS, the Alternative Minimum Tax, the reduction of the R & D Tax Credit and the Foreign Sales Corporation exemption. When all the parts are examined and compared there remains little room for question that both tax reforms constitute a major, real threat to U.S. international competitiveness. Moreover, it is particularly unfortunate that such a threat should hang over the American economy when you consider that a ready alternative is at hand, namely the Business Transfer Tax (BTT) or some variation thereof.

The BTT is capable of raising the necessary revenues to maintain revenue neutrality under the individual and corporate rate reductions while actually promoting the competitive position of the U.S. The BTT is rebated at the border for U.S. exports, thereby accomplishing in full the goal of the Foreign Sales Corporation; it taxes U.S. imports at the border, thereby imposing a tax on goods that were lightly taxed at home and bringing such goods onto a more level field with U.S. goods; and it automatically expenses all business outlays including capital formation and R & D, thereby avoiding the pitfalls of multi-period capital recovery systems.

One must hope that the President and the Congress will recognize the threat to the American economy involved in their tax reform proposals. It must also be hoped that they will respond to this threat, not by dropping the reform effort, or the original goals laid out to guide tax reform, but by recognizing that these goals have not been achieved and that there is a pro-growth, pro-competitiveness alternative available to meet these goals.

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Testimony of Sharon M. Pollard
Secretary of Energy Resources
Commonwealth of Massachusetts
to the
Subcommittee on Energy and Agricultural Taxation
Senate Finance Committee
Hearings on Proposed Oil Import Fee
February 27, 28, 1986

I am pleased that the Committee decided to hold these hearings. This opportunity allows me to convey to you my deep concern that fees on imported oil will have serious impacts on the citizens of Massachusetts and other Northeastern states.

Some proponents of oil import fee legislation have suggested that the measure is needed to reduce the U.S. dependency on foreign oil, discourage consumption and encourage U.S. production. I am sure that most everyone would agree that this nation's dependence on oil imports should be reduced. Others support a fee as a way to raise billions of dollars in tax revenues to reduce the budget deficit.

In any case, the question before us really is: despite the initial attractiveness of an oil import fee to reduce imports and generate revenue, do the costs of such an action outweigh the benefits?

Therefore, the basic theme which I intend to stress to you is that the burden of an oil import fee will be unevenly and unfairly distributed. New England, especially Massachusetts, will be hurt the most due to its reliance on oil.

Let me provide you with some perspective of the percentage of oil consumed in the New England states as compared to the national average:

Petroleum Percentage of Total Energy Consumed

State	Residential Sector (%)	State Total (%)
CT	34.8	67.5
ME	44.4	69.8
MA	30.6	64.6
NH	39.1	63.6
RI	28.9	53.5
VT	32.0	52.8
Regional Average	35.0%	62.0%
National Average	9.7%	42.6%

I can also say that New England has historically been paying the highest energy costs in the nation. The cost of energy in Massachusetts is approximately 21% above the nation's on a BTU basis. Any increases in oil prices due to an import fee without corresponding tax increases in other forms of energy will penalize this region much more than other regions of the country.

Because Massachusetts has few indigenous energy resources, almost all of its energy expenditures flow out of state, either to foreign suppliers or to other states. Massachusetts has estimated that about $7.7 billion out of a total state energy bill of $9.27 billion left the state.

Further analysis by my office indicates that even a $5 per barrel increase on imported oil would raise oil prices approximately 12¢ per gallon. This assumes that initially imported crude oil prices would rise as a result of the fee. In turn, domestic crude prices would rise to reach market levels. Given that Massachusetts is 65% dependent on foreign oil, such a fee would add $660.6 million to the Commonwealth's energy bill. Each household would spend an average $315 more on energy. The added energy bill amounts to $116 per Commonwealth resident. More importantly, the effects on low-income families could be devastating. For New England as a whole, the cost would be over $1.5 billion annually.

This dollar outflow would reduce demand for other goods and services, adversely affecting businesses, increasing unemployment, and contributing to inflation. An oil fee increase could make this region less attractive to business and industry and thus less competitive with other regions. In other words, we are concerned that a greater share of the revenues generated by the fee will come from this part of the country, with few, if any, benefits flowing back.

Another question remains on whether a fee in any form is an acceptable method of encouraging conservation. We in Massachusetts say that a fee is not the answer. Through aggressive energy conservation, Massachusetts has been able to play a major role in reducing foreign oil dependency. At one point, our dependency on oil for energy was almost 80%. It is now 65%.

It was through the concerted efforts of all Massachusetts citizens that the conservation challenge was met and our petroleum needs reduced. This meant expanded use of coal; expanded conservation programs in all sectors; and an expanded role for alternative energy which includes cogeneration, solar, and hydro. Although we will continue with these efforts, we view the the current proposed fee as a discriminatory penalty on the economy of our region.

At this point, I will not reiterate the details of what many reports have said about the detrimental results of such a fee (i.e. higher inflation, more unemployment, economic strains on friendly foreign producers, etc.). I do, however, want to emphasize that any type of fee, in my opinion, is a means for the federal government to once again regulate the oil industry. It has been well documented by such agencies as the General Accounting Office that, in the past, the bureaucracy involved with regulating aspects of the oil industry has been chaotic. I can foresee the many regulatory complexities in the proposed fee legislation. Already there has been talk that perhaps some countries will need concessions and/or exemptions.

In conclusion, I will say again that I am pleased that you have held these hearings. It is absolutely essential that you consider the discriminatory regional impacts of the proposed legislation. It is our strong belief that the negative effects far outweigh any benefits.

Testimony

from the

National Asphalt Pavement Association

for submission to

The Energy and Agricultural Taxation Subcommittee

of the Senate Finance Committee.

Hearing Date: February 27 & 28, 1986

Hearing Topic: Taxation of Imported Oil

The National Asphalt Pavement Association (NAPA) is the only national trade organization which specifically represents the Hot Mix Asphalt Industry. This Industry is responsible for producing and placing the material that surfaces approximately 93% of the nation's paved roads. The primary component of this product is asphalt cement, a petroleum by-product which is derived from both domestic and imported crude oils, as well as being imported as a finished product. We have, therefore, a considerable interest in any oil import fee proposals which may be under consideration.

As an organization, NAPA has a long history and policy of considering and supporting activities on the basis of whether they are, first and foremost, best for America; second, best for the Hot Mix Asphalt Industry; and third, best for the Association. It is our strong belief that a strong and healthy nation fosters the best environment for free enterprise as well as for business success. In line with this policy, NAPA has consistently supported reasonable proposals for reducing the federal deficit, and we appreciate the efforts of this subcommittee in seeking these same ends.

In the consideration of an oil import fee, however, we would wish to draw to the subcommittee's attention the impacts that such a fee could have on the nation's transportation and other public works systems and the agencies which are responsible for their construction and maintenance.

The primary use of the aforementioned asphalt cement is transportation oriented in the form of highways, roads, streets and airport runways.

Other applications include environmental facilities such as sanitary landfill liners, sewage ponds, water storage facilities and as facings for earth-filled dams, as well as for recreational resources such as bike paths, running tracks, tennis and basketball courts and playgrounds.

The majority of these facilities, as is readily apparent, are constructed for the public benefit under the aegis of governmental agencies on the federal, state and local level. In fact, more than 80% all asphalt cement used each year in the United States is purchased by governmental entities for such public uses. Therefore, any action that has an impact upon the cost of the asphalt cement also has a direct impact upon the construction and maintenance of these facilities.

Due in part to the well publicized decline in the domestic refining industry, coupled with technical innovations which have increased the proportion of light products refined from each barrel of oil, adequate domestic supplies of asphalt cement have not been available to meet the nation's demands. Imports of finished asphalt cement constitute less than 1% of total refined product imports, while the proportion of imported crude oil converted into asphalt cement amounts to less than 3% of the nation's annual crude imports.

The point we would like to make is that an oil import fee would increase the cost of the most significant product used in the construction of pavements. Such an increase would have a number of readily foreseeable effects to which we would like to direct the subcommittee's attention.

In light of the great concern which exists over the state of the nation's infrastructure, it would seem counter-productive to add to the already staggering costs to repair and rebuild many of these facilities by increasing construction costs through the imposition of a tax on a basic construction material.

As stated previously, the primary consumers of our product are governmental agencies, which finance their construction programs through tax revenues derived from user fees and fuel taxes. The imposition of an oil import fee on asphalt cement would create a tax on these tax revenues, reducing the amount of work which could be performed and negating much of the public benefit derived from highway construction and maintenance. We believe that the governmental agencies responsible for highway construction were looking forward to less expensive asphalt as a way of maintaining highway programs in the face of budgetary cut-backs and reductions.

Any significant import fee would also have the effect of not only reducing the demand for the product, but would also have ramifications in lowering construction industry employment.

It should also be noted that the bidding for, and the letting of, construction contracts frequently occurs as much as two years in advance of actual construction, while the price of petroleum products delivered to contract sites are priced as per the actual date of delivery. It is therefore, extremely difficult for the private contractors to forecast their costs and thereby submit competitive bids unless there is stability in the market. Congressional consideration of oil import fees has already caused consternation in the industry concerning future oil and asphalt prices and could lead to a chilling in highway contract bidding which will be felt for several years to come.

In 1975, in the face of rapidly increasing oil prices, many state and local agencies enacted price adjustment clauses to give some protection to long-term contracts where significant increases in material costs were incurred pursuant to the date of bidding. Few of these agencies still maintain these clauses and if Congress chooses to impose an oil import fee, some consideration will be needed for the provision of a similar means of protecting contracts which have been bid and let on the basis of current costs which may be lower than the costs which would result from Congressional mandates.

On the basis of these points, we would respectfully request that the subcommittee contemplate the exemption of asphalt cements from any import fees, specifically, that proportion of the barrel of crude oil which is processed into asphalt cement and that proportion of petroleum product imports which are brought into this country in the form of finished asphalt cement.

We are well aware of the number of comments and amounts of input the subcommittee has received on this issue and we have consciously attempted to keep our comments to a minimum. We would be happy to supply the subcommittee with further details and documentation if they are desired.

national grange

1616 H STREET, N.W. WASHINGTON, D.C. 20006 (202) 628-3507

Edward Andersen, Master

March 13, 1986

The Honorable Robert Packwood
Chairman
Senate Finance Committee
259 Russell Senate Office Building
Washington, D.C. 20510

RE: February 27 and 28, 1986
Oil Import Fee Hearing

Dear Mr. Chairman:

The National Grange, on behalf of its 400,000 members, urgently requests that the Senate Finance Committee oppose a tax on crude oil. The Grange opposes such a tax for use in deficit reduction, to produce a revenue-neutral tax reform bill or for any other purpose.

Petroleum products have both a direct and indirect effect on the cost of production for farmers and ranchers. Petroleum-based inputs are one of the largest, if not the largest, costs that are incurred in agricultural production. As the price of crude oil escalated in the 1970's, farmers suffered financially from increased production costs. Now that crude prices are falling, farmers have the opportunity to narrow their cost-price squeeze.

Net farm income has decreased steadily over the last several years and will continue to decline for the next few years. The Food Security Act of 1985, by lowering support prices, holds little promise of reversing this trend in the immediate future. A ray of hope for income improvement for agriculture is decreased input costs that will help offset the reduced farm prices. A reduction

The Honorable Robert Packwood
Page 2
March 13, 1986

in crude oil is a means to that end and will be beneficial to American farmers. Any action by Congress to keep oil prices artificially high will be detrimental to an already wounded farm economy. It is vital to farm income, the structure of agriculture, and the future of rural America for oil prices to continue their decline without artificially supporting the price of crude oil through a tax to cover up shortcomings of our national tax structure or fiscal policy.

Furthermore, economists cannot agree on the degree of benefit to the Treasury from an oil tax, or if there even is a benefit. An oil tax will be, at best, a short-term infusion of funds into the Treasury. A long-run analysis indicates that the reduction of oil prices, which, in turn, will reduce input prices, assists in decreasing inflation, increasing real growth, and decreasing unemployment. These side effects will produce more revenue for the Treasury and will have a stronger effect on our goal of reducing the national deficit than will an oil tax.

The state of the national economy has a major effect on the agricultural sector since 20 percent of the employment is related to the food sector. As the economy of the country brightens, the prosperity of the farming sector grows. Allowing the economy of the country to grow will make America stronger and will assist the American farmer in competing in the world market.

For these reasons, we respectfully urge that a tax on crude oil be opposed. Thank you.

Respectfully,

Edward Andersen

Edward Andersen
National Master

EA/mmp

OPCON

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Low Oil Prices Today, Spell Trouble for Consumers Tomorrow

1. Introduction

Practicing the 500 Points of Good Husbandry should be first and foremost to consumers of oil products and managers in the oil and gas business today. But just the opposite seems to be the case. Warm fuzzy blankets of complacency are engulfing energy consumers, and cold chilly bankruptcy fears are preoccupying energy producers. As reported by Hertz, the car rental agency, travel distance has increased 6.8 percent in the last two years and is predicted by Hertz's auto researcher Leigh Smith to be even higher in 1986. Investment in oil/gas exploration is in the wings, not center stage. The Hughes active rig count is near the 1973 level. Stocks of crude oil and oil products are at an all-time low because everyone expects that the glut is here to stay.

This setting for world oil in general and U.S. gas in particular has significant implications for Free World buyers and sellers of energy. Several experts in the Summer 1985 issue of American-Arab Affairs provided "landscape premises" for all to ponder. Wilkinson, Chief Economist of Sun Oil wrote"

> "With the world economic recovery, the dollar weakening, and oil prices stable or declining in the near term, a case can be made for a greater than expected increase in demand." (p. 104)

Seymour, Managing Editor of Middle East Economic Survey said"

> "In 1985 and 1986 most if not all of the oil demand growth is likely to be preempted by additional non-OPEC supplies; but after that, OPEC oil is expected to make greater headway as non-OPEC reaches a plateau." (p. 73)

Ait-Laoussine and Parra, Pres. and V.P. of Int. Energy Dev. Corp., pointed out:

> ". . . the massive investments made since 1973 have produced rather little in the way of incremental production outside of the OPEC area. . . of the increase that did occur over 75 percent came from Mexico and North Sea" (pp. 75, 76)

Seymour credited Pierre Desprairies of Institut Francais du Petrole as saying:

> "Before 1980 the cost of finding and producing an incremental barrel was $5-$10 a barrel. Now with the exception of the Middle East, it is some $15 a barrel and moving towards $20 a barrel." (p. 93)

Taher, Governor of Petromin and Minister of State of the Kingdom of Saudi Arabia, wrote:

> "1970 to 1973 was the beginning of the period of rising real oil prices, which happened to coincide with both the peaking of oil and gas production in the United States and an economic boom in the industrialized countries." (p. 59)

Uncertainty in Crude Oil Prices

The uncertainty in crude oil prices was graphically portrayed by Conoco, Inc, in 1985. See Figure 1.1. Conoco's projections for 1986 through 1995 varied from a low in the high teens to a high near $40/bbl. Also, uncertainty typified the U.S. Department of Energy's projections in its Annual Energy Outlook 1984. See Figure 1.2. DOE projected a range of prices from a low near $20/bbl. in the last half of the 1980's to a high of around $50/bbl. in 1995. More confidently, the Gas Research Institute in its Gas Research Insights, May 1985, projected world oil prices would follow close to DOE's Base Price projection: $26/bbl. in 1986, $24.7/bbl. in 1987, $25/bbl. in 1988, $25.50/bbl. in 1989, $26/bbl. in 1990 and $38.49/bbl. in 2000, all in 1984 dollars. Interestingly, none of these forecasts were as pessimistic as A. R. Tussing's projections. Tussing in his OPEC Obituary in Public Interest Journal, Winter 1983, said:

> "The most stable and easily sustainable price range is probably on the order of $10 to $18 per barrel (in 1982 constant dollars), delivered to the world's major consuming regions."

Tussing further said:

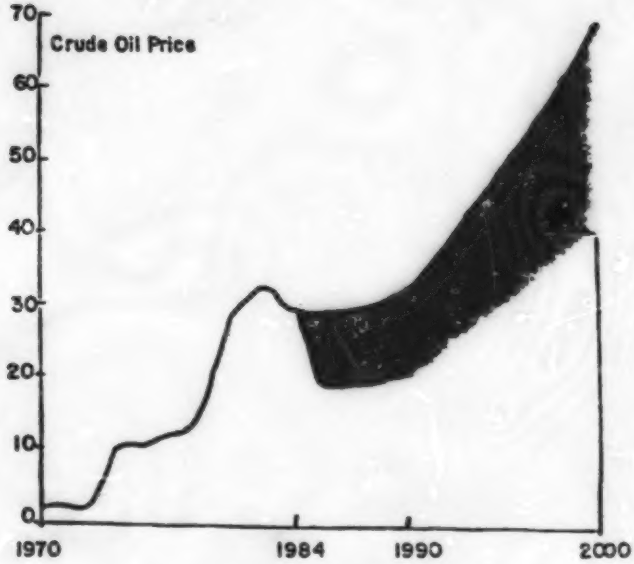
> "There is no basis in geology, resource economics or history for predicting a never-ending increase in the real price of oil."

Today, Tussing's forecast of the oil price seems closer to the mark than those of DOE, Conoco and GRI. However, his reasoning for that forecast seems highly questionable.

Purposes of OPCON's World Oil Modeling

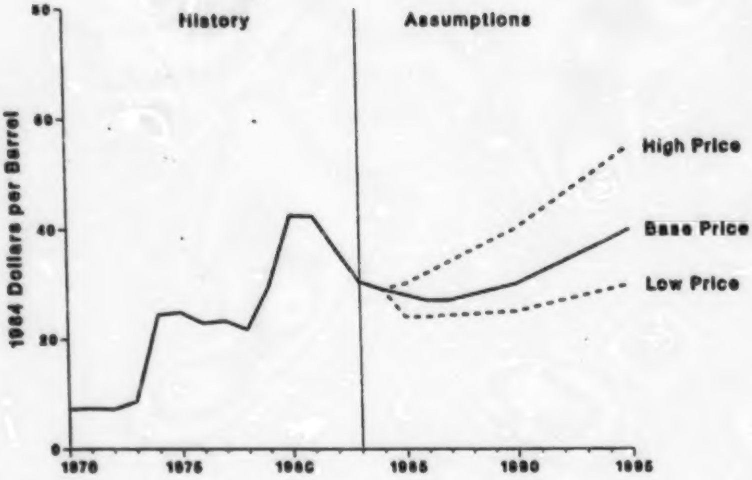
The primary purposes of OPCON's World Oil modeling were (1) to find analytical expressions which represented the demand and supply components in the world oil market and (2) to fit all of these expressions together into a working computer program to forecast the crude oil price. This

FIGURE I.I: Conoco, Inc. Crude Oil Price Projection



Source Conoco Inc.

Figure 1.2. World Oil Prices, 1970-1995



Note: All prices are the cost of crude oil to U.S. refiners.

Source: Annual Energy Outlook 1984
Energy Information Administration

purpose was accomplished by fitting demand, supply, inventory and price response equations to reported historical data. The data for estimating the demand, supply and inventory complnents represents the last 25 years of behavior. The resulting modeling solutions show the fundamental effects of oil prices on worldwide economic growth, in addition to Non-OPEC production. This price/growth linkage shows the dominating effect of the economics, not necessarily the politics, on the world oil market.

2. World Oil Model

OPCON's World Oil Model has the following components:

- World Demand
- Non-OPEC Supply
- Inventory Adjustment
- OPEC Price Response

The world oil demand represents estimated demand functions for the U.S., Canada, U.K., W. Germany, Japan and Italy. In each case, demand function formulations follow the U.S. demand function description in OPCON's Fuels Model as used for the Natural Gas Supply Association (NGSA) Block Pricing Analysis in November, 1985. The NGSA study was placed in the public domain 25 Feb. 1986, when the NGSA filed it with the Federal Energy Regulatory Commission. The quantity demanded is a function of the oil price and real income. World oil demand is a function of not only the economic demands in these six countries, but also the trend in demand growth for the rest of the world. See Figure 2.1.

Real economic growth in each of the six countries is a function of the world oil price. That is, in periods of increasing oil prices, real economic growth is decelerated; and in periods of decreasing oil prices, real economic growth is accelerated. Further, the price of oil in the demand functions is in each of the six countries' own currency. Thus, the financial effects of variations in foreign exchange rates for the U.S. dollar are captured in the economic demands for oil. It is important to note that the world oil price is denominated by OPEC in U.S. dollars.

The Non-OPEC supply component represents the estimated supply functions for the U.S. and the rest of Non-OPEC. Both components are functions of the oil price, plus the geological relationships which are associated with new and oil fields. These relationships follow Hubbert's analysis for the U.S. Geological Survey. See Hubbert, M. K., "U.S. Energy Resources: A Review as of 1972," U.S. 93rd Congress, 2nd Session, Senate Committee on Interior and Insular Affairs, Serial No. 93-40 (92-95), 1974. The U.S. component includes an additional variable to historically capture the pro-rationing effect of the Texas Railroad Commission. See Figure 2.2.

The inventory adjustment model represents the change in oil inventory as a function of the strategic petroleum reserve (SPR), the change in the price and the economic costs of carrying inventory. SPR stock is expressed relative to real U.S. gross domestic product. Total stocks represents the sum of oil stocks in the U.S., Canada, U.K., W. Germany, Japan and Italy. Stocks in the five countries other than the U.S. are expressed relative to U.S. private stocks.

Figure 2.1.

Six Industrialized Country Petroleum Product Demand, Actual (Points) and OPCON Fit (Line)

Operational Economics, Inc., Houston, TX.

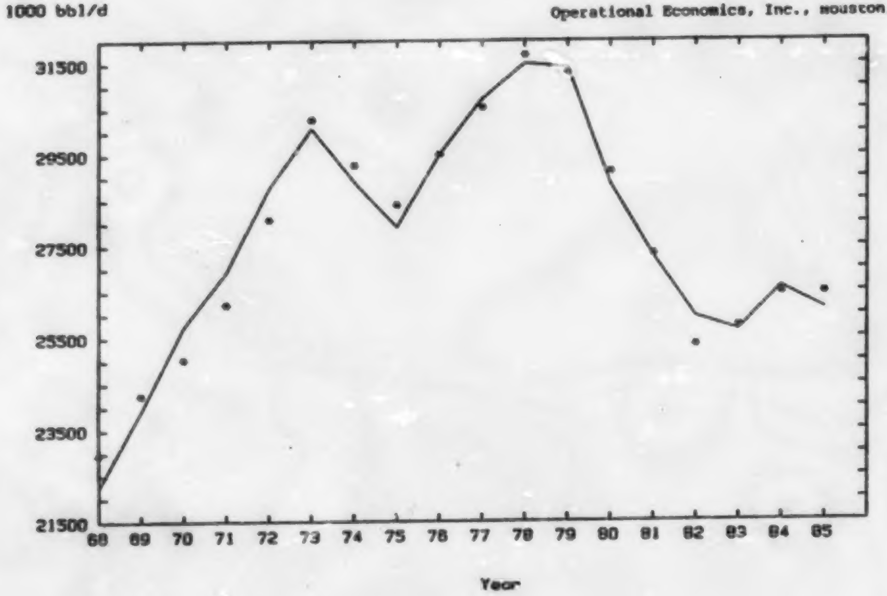


Figure 2.1a.

U. S. Petroleum Product Demand.
Actual (Points) and OPCON Fit (Line)

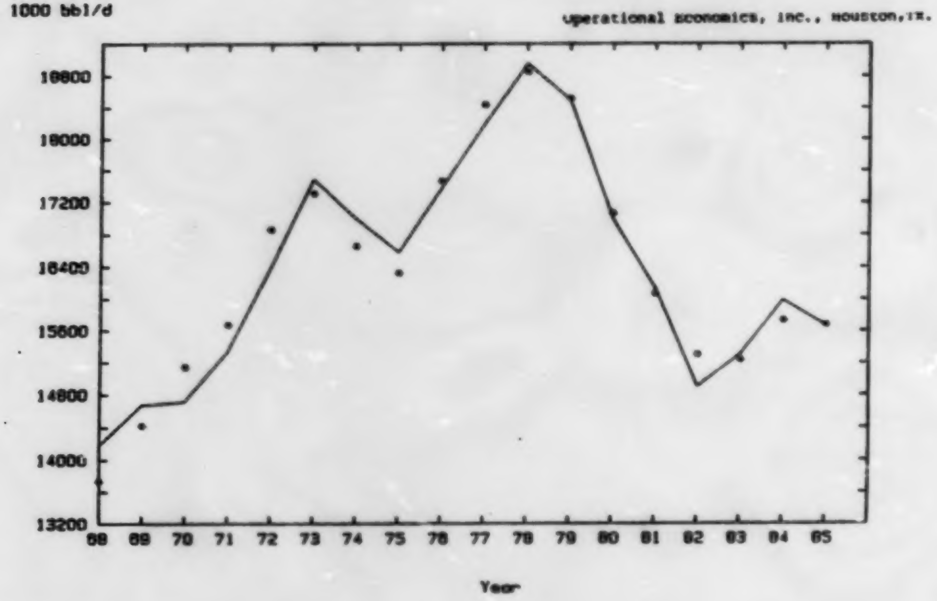


Figure 2.2.

Non OPEC-Non U. S. Crude Production,
Actual (Points) and OPCON Fit (Line)

Operational Economics, Inc., Houston, TX.

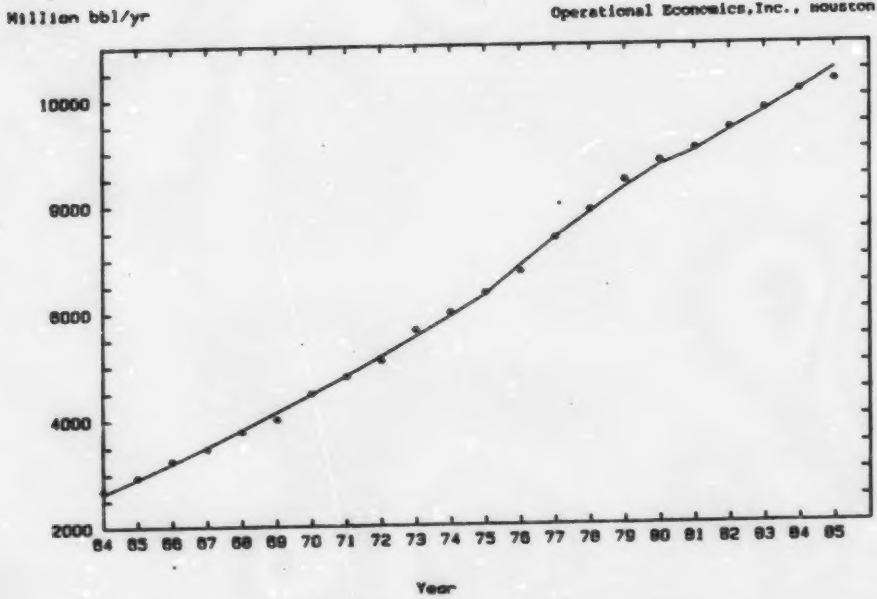


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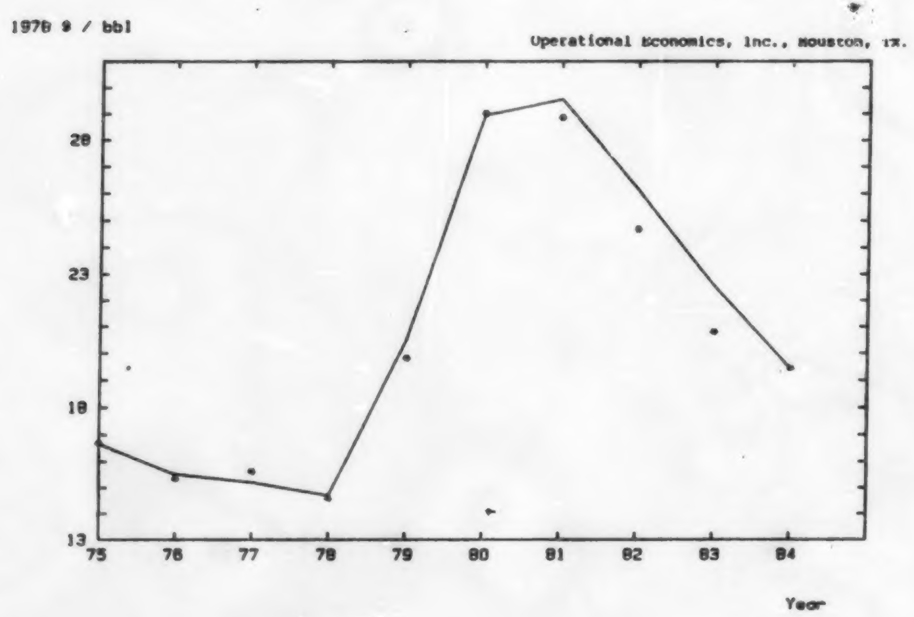
Figure 2.3.

Real World Oil Price as a Function of OPEC Capacity Util
Actual (Points) and OPCON Fit (Line)



Operational Economics, Inc., Houston, TX.

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OPEC is assumed to be the residual oil supplier. It is assumed to price its oil relative to the utilization of its capacity, following the U.S. Energy Information Administration. That is, for price increases, the percentage increase in OPEC's price is an increasing function of its capacity utilization; and for price decreases, the percentage decrease in OPEC's price is a decreasing function of its capacity utilization. It is estimated from historical data, which includes the Central Intelligence Agency's estimate of OPEC capacity utilization. See Figure 2.3.

The World Oil Model represents an interactive computer programmed synthesis of the demand, supply and inventory components stated above. It is used not only to forecast the world oil price, but also world oil demands, oil supplies of Non-OPEC, inventory adjustments, and oil supplies of OPEC. Most importantly, the forecasts show when the oil market will turn from favoring buyers to favoring sellers.

Data

The data for the estimation were obtained from publically available records. The annual data series represent statistics from the early 1960's. All price and value data are denominated in 1978 U.S. dollars. Primary data sources were BP Statistical Review of World Energy by British Petroleum, Basic Petroleum Data Book by American Petroleum Institute, Monthly Energy Review by Energy Information Administration, Main Economic Indicators by Organization for Community and Economic Development, European Economy by Commission of European Communities, and Foreign Exchange Rates by U.S. Federal Reserve System. In addition, the U.S. Central Intelligence Agency's economic and energy statistics are the data sources for OPEC's maximum production capacity and oil consumption in U.K., W. Germany, Canada, Japan and Italy; see, for example, Handbook of Economic Statistics and International Energy Statistical Review.

3. Basis for Analysis

Primary Assumptions

The primary initial assumptions for the world oil modeling analysis were as follows for the Base Case:

- Real gross domestic product will grow at the following rates per year in the six leading countries:

	U.S.	Canada	U.K.	W. Germ.	Japan	Italy
1986	4.2	2.2	2.3	1.8	4.5	1.5
1987	3.8	2.2	2.3	1.8	4.5	1.5
1988	3.3	2.2	2.3	1.8	4.5	1.5
1989	2.7	2.2	2.3	1.8	4.5	1.5
1990	2.5	2.2	2.3	1.8	4.5	1.5

The real growth rates from 1991 through 1995 are the same as in 1990.

It is noteworthy that these rates change internally in the iterative modeling analysis as the World Model computes a market-clearing solution.

- Foreign exchange rates for the U.S. dollar are specified to generally follow depreciating rates of the U.S. dollar as typical of trends in much of the 1970's. For example, the West German mark appreciates from 49.4 U.S. cents per mark in 1986 to 69.0 U.S. cents per mark in 1995.

- The quantity of oil produced in Alaska will be 1808.22 thousand barrels per day in 1986, 1987, 1988 and 1989. This production will decrease to 1780.82 thousand barrels per day in 1990 and 1753.42 thousand barrels per day in 1991. It decreases steadily to 1644 thousand barrels per day in 1995.

- The maximum capacity of OPEC to produce oil increases from 29.1 mil. bbls. per day in 1985 to 29.4 mil. bbls. per day in 1986. It then decreases back to 28.2 mil. bbls. per day in 1987. After 1988, this capacity limitation increases steadily to 35.5 mil. bbls. per day in 1994, which is between the 1978 and 1979 OPEC capacity level.

In a revision of the Base Case, variations were made to reflect an arbitrary $18/bbl. crude oil price in 1986, plus an alternative formulation to accelerate OPEC's price response as its capacity utilization varies. Further, OPEC production capacity remains near the 1985 level in 1986. It falls slightly in 1987 and 1988 and increases slowly thereafter toward 35 million barrels per day in 1993.

4. World Oil Demands and Supplies

Statistics for the years 1974 through 1985 and Base Case forecasts for the years 1986 through 1995 are presented in Table 4.1. Several points are immediately evident from these statistics and forecasts. Primary emphasis is directed in the discussion to the Base Case. However, the differences

Table 4.1. -- Base Case

Statistics and Forecasts of World Oil Demand and Supplies for Lower-48 States U.S., Non-OPEC Excluding U.S., and OPEC, Statistics and/or Estimates, 1974-1985, Forecasts 1986-1991

	Demand 1000 bpd	Crude Production 1000 bpd		
	World Products	U.S. L-48	Other non OPEC	OPEC
1970	45784	9405	12263	23885
1971	48458	9245	13126	25803
1972	52061	9266	13932	27556
1973	56189	9010	15477	30989
1974	55433	8582	16348	30729
1975	54720	8184	17351	27156
1976	58130	7958	18441	30737
1977	59963	7780	20142	31299
1978	61883	7478	21545	29805
1979	62743	7150	23055	30929
1980	60257	6976	24049	26890
1981	58272	6964	24682	22647
1982	56730	6954	25734	18868
1983	56110	6974	26723	17584
1984	57049	7158	27674	17575
1985	58613	7132	28184	15529
1986	60368	7119	29034	16563
1987	62664	7048	29419	18396
1988	66574	6990	29687	21769
1989	72197	6939	29710	26823
1990	76566	6898	29676	30866
1991	76840	6867	29715	31172
1992	76447	6855	30265	30223
1993	77387	6865	31547	29771
1994	77929	6884	33193	28629
1995	76594	6902	34923	25704

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Table 4.2 -- Base Case Revised

Statistics and Forecasts of World Oil Demand and Supplies for Lower-48 States U.S., Non-OPEC Excluding U.S., and OPEC, Statistics and/or Estimates, 1974-1985, Forecasts 1986-1991

	Demand 1000 bpd	Crude Production 1000 bpd		
	World Products	U.S. L-48	Other non OPEC	OPEC
1970	45784	9405	12263	23885
1971	48458	9245	13126	25803
1972	52061	9266	13932	27556
1973	56189	9010	15477	30989
1974	55433	8582	16348	30729
1975	54720	8184	17351	27156
1976	58130	7958	18441	30737
1977	59963	7780	20142	31299
1978	61883	7478	21545	29805
1979	62743	7150	23055	30929
1980	60257	6976	24049	26890
1981	58272	6964	24682	22647
1982	56730	6954	25734	18858
1983	56110	6974	26723	17584
1984	57049	7158	27674	17575
1985	58613	7132	28184	15529
1986	61121	7119	29034	17222
1987	64499	7048	29419	20086
1988	68531	6986	29509	23802
1989	72162	6932	29417	27116
1990	72717	6890	29341	27676
1991	73305	6868	29710	27905
1992	74533	6869	30737	27886
1993	76897	6886	32428	28449
1994	77558	6904	34177	27331
1995	74648	5917	35768	23131

between that case and Base Case Revised are shown in the figures cited.

- The world demand for oil peaked at 62.7 million barrels per day in 1979 and decreased 11.5% thereafter to 56.1 million barrels per day in 1983. It increased 1.6% to 57.0 million barrels per day in 1984 and increased 2.8% to 58.6 million barrels per day in 1985. Economically, the positive effect of continuing real economic growth more than offset the negative effect of the oil price starting in 1984. Since then, a turnaround in oil demand growth has been slowly getting underway. It is projected to continue at 3.0%/yr. in 1986 and 3.8%/yr. in 1987, after which it accelerates to 6.2% in 1988 and 8.4% in 1989. It then decelerates to 6.1% in 1990 and .36% in 1991. A peak demand of 77.9 million barrels per day is attained in 1994, which is 24% greater than the peak observed in 1979. See Figure 4.1.

- Non-OPEC oil production excluding the U.S. increased 32% from 1974 through 1978, and it increased nearly 4%/yr. (3.9%/yr.) from 1978 through 1985; however, the rate of increase has been gradually diminishing from its high level of 7% from 1978 to 1979 to its low level of 1.8% from 1984 to 1985. Production of Non-OPEC excluding the U.S. is projected to reach 29 million barrels per day in 1986. It will be between 29.4 to 29.7 mil. bbls. per day in the late 1980's, and it will hold near 29.7 mil. bbls. per day in 1989, 1990 and 1991. Non-OPEC production excluding the U.S. will not increase into the 30 mil. bbl. per day range until 1992. See Figure 4.2.

- The quantity of oil produced in the Lower 48 States has decreased steadily at approximately 0.7% per year from 1978 through 1985, and it is projected to decrease at slightly less than this rate (0.4%/yr.) from 1985 through 1995.

- OPEC oil production decreased nearly 50% from its peak in 1979 to its trough in 1985 (30.9 million bbls. per day in 1979 vs. 15.5 million bbls. per day in 1985). The rate of this decrease has been especially pronounced in the 1980's to date, because of the relatively long-lags in the demand response to price, for example, four to six years. However, the modeling results show that that demand adjustment effect has largely run its course, and that increasingly larger supplies of oil from OPEC will be required starting in 1986. For example, after the turnaround in 1986, 11% more OPEC supply will be required in 1987, 18% more in 1988, and 23% more in 1989. Between 1989 and 1991, OPEC is projected to supply all of the growth in world demand, plus the decline in U.S. supply. Also, in that period, Non-OPEC production will hold constant at 29.7 mil. bbls. per day. See Figure 4.3.

- Demand for OPEC oil will approximately double in the six years from 1985-1991 (15.5 mil. bbls. per day in 1985 to 31.2 mil. bbls. per day in 1991). This level of OPEC supply will approximately equal that of its peak year in 1977 (31.3 mil. bbls. per day).

Figure 4.1.

World Demand for Petroleum Products (BP statistical series)
1000 bpd

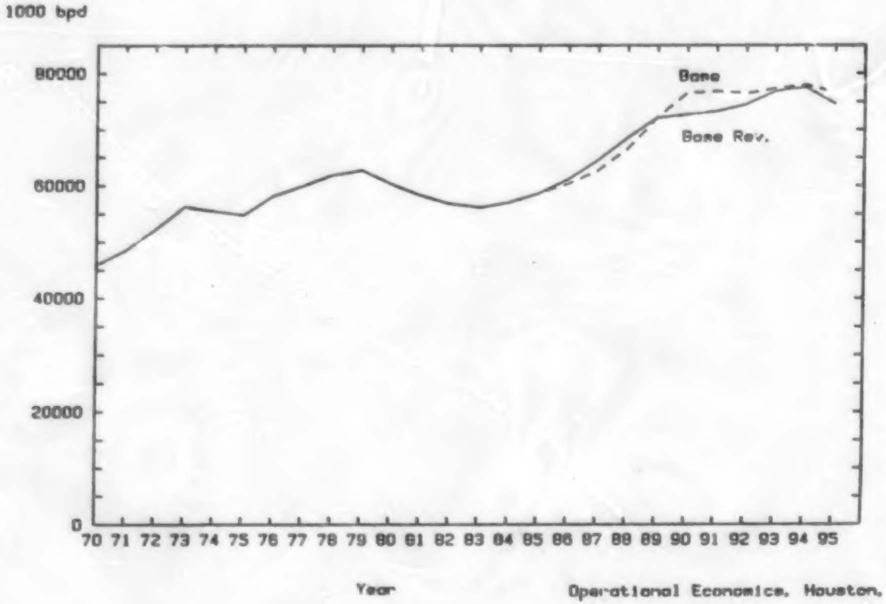

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Figure 4.2.

Non-OPEC Production Rate, Thousand Barrels per Day

Operational Economics, Houston, Texas

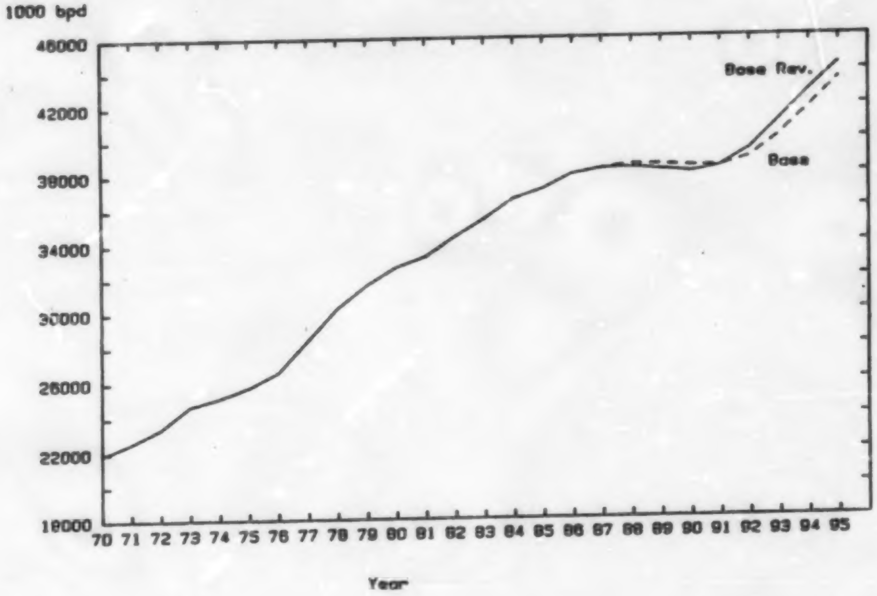
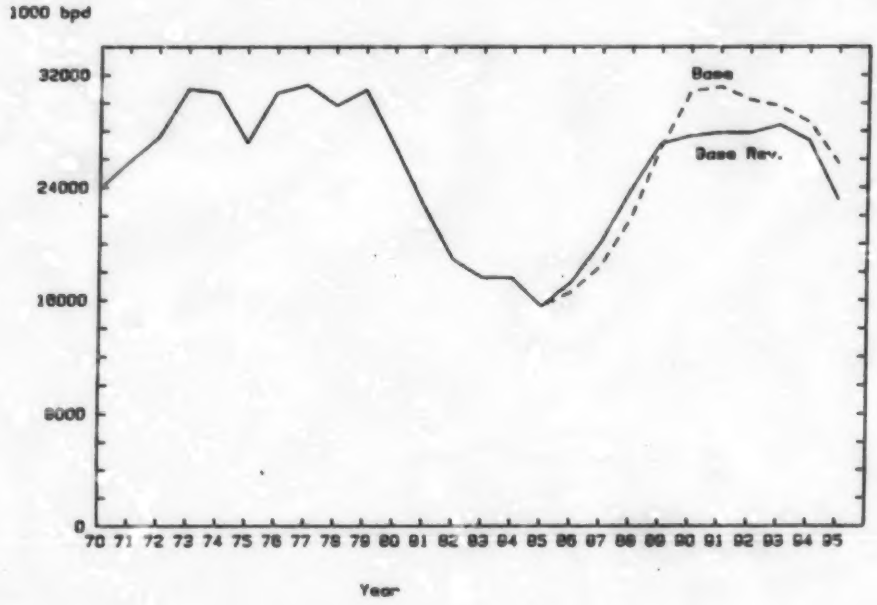


Figure 4.3.

OPEC Production Rate, Thousand Barrels per Day

Operational Economics, Houston, Texas



- The difference between the world oil demand and the world oil supply (sum of U.S., Non-OPEC Excluding U.S. and OPEC supplies) is the forecast level of the change in oil stocks. The change in stocks is positive in every year from 1986 through 1995.

- The growth in oil demand results primarily from the lower price and the acceleration of economic growth which is stimulated by lower oil prices in the mid-to-late 1980's. For example, real economic growth in the U.S. is 5.1% in 1987, 4.4% in 1988 and 3.4% in 1989. Similarly, real economic growth in Japan is 6% in 1986, 5.8% in 1987, 5.1% in 1988 and 4.8% in 1989. These computed growth rates are significantly higher that the initial asrumptions stated above.

5. World Oil Prices

In the Base Case, world oil prices fall from $27.11/bbl. in 1985 to $23.34/bbl. in 1986, as annual averages. The annual average price falls another $3.27/bbl. between 1986 and 1988. Thereafter, the world oil price increases at an increasing rate as increasingly greater pressure is placed on OPEC's production capacity. The world oil price increases from $20.07/bbl. in 1988 to $71.21/bbl. in 1991. This 1991 price would translate into a real price 14% higher than the real price in 1980 (in 1978 dollars). See Table 5.1 and Figure 5.1. Still higher prices are forecast for 1992 ($87.06/bbl.), 1993 ($95.39/bbl.) and 1994 ($96.28/bbl.). The real price in 1978 dollars in 1993 is forecast to be 30% higher than the comparable real price in 1980.

In the Base Case Revised, the world oil price falls from $27.11/bbl. in 1985 to $16.64/bbl. in 1987. This 1987 price translates into oil at $9.50/bbl. in 1978 dollars, which would be 35% below the price actually paid in 1978. However, even in this case, the world oil price increases from $16.64 /bbl. in 1987 to $81.67/bbl. in 1991 (nominal dollars). It further increases to a peak of $88.77/bbl. in 1993. Thus, the Base Case Revised would not affect much at all the timing for the turnaround in the oil price. It would only diminish the peak price in 1993 by 7%. Low oil prices in the near term clearly spell trouble for oil consumers in the longer term.

6. Litmus Test of Principles and Salient Policy Implications

As quoted above, Tussing said that "The most stable and sustainable price range is probably on the order of $10 to $18 per barrel (in 1982 constant dollars), . . ." He further said that "There is no basis in geology, resource economics or history for predicting a never-ending increase in the real price of oil." A test of the plausibility of Tussing's statements was made by fixing the real price of oil at $14/bbl. in 1982 dollars (or $10.28/bbl. in 1978 dollars) for the forecast period. OPCON's World Oil Model gave a world oil demand of 121.5 mil. bbls. per day in 1995, of which OPEC supplies 70.6 mil. bbls. per day. This extreme level of OPEC production would significantly exceed its capacity. Similar ridiculous results for world demand and OPEC production were obtained for other fixed oil prices in the Tussing range. In fact, ludicrous modeling results would be found for every fixed oil price in that range. Thus, Tussing's forecast of a relatively constant real oil price in the $10/bbl. to $18/bbl. range (in 1982 dollars) is not only highly unlikely, but totally implausible. Further, the modeling results lend definite support to a counter-positive revision of Tussing's oil market characterization. That is, there is a basis in geology, resource economics, and history for anticipating generally increasing real prices of oil. See Figure 6.1.

Barring government intervention by the leading oil consuming nations, increasingly greater price uncertainties will emanate from the world oil market to the market economies of these nations at large. The growing concentration of the world oil market power in the large reserve holders of OPEC will cause increasing risk aversion in all types of long-term investments. The limit of this risk aversion may give rise to a worldwide

Figure 5.1.

World Oil Price (DOE Refiner Acquisition Cost, Imports)
Nominal Dollars per bbl

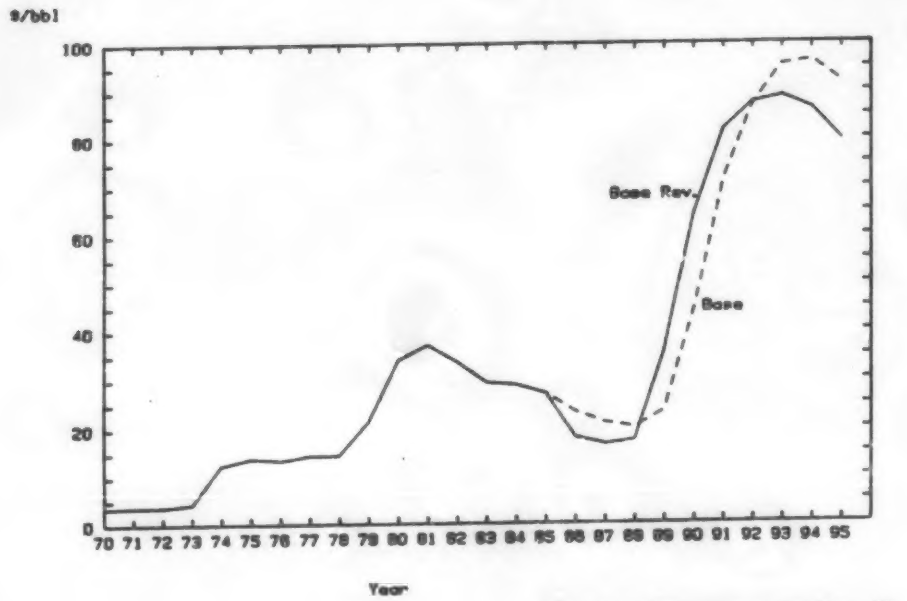


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Figure 5.1a.

World Oil Price (DOE Refiner Acquisition Cost, Imports)
1979 Dollars per bbl

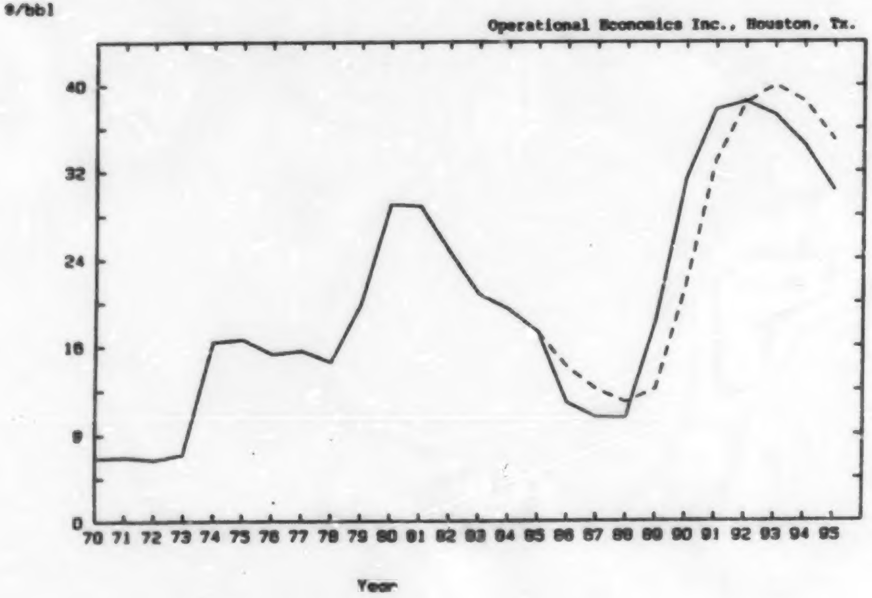

Table 5.1 -- Oil Prices -Base Case and Base Case Revised

	Base Case		Base Case Revised	
	World Price current $/bbl	Price in 78 $ per bbl	World Price current $/bbl	Price in 78 $ per bbl
1970	3.53	5.87	3.53	5.87
1971	3.76	5.96	3.76	5.96
1972	3.76	5.71	3.76	5.71
1973	4.32	6.21	4.32	6.21
1974	12.52	16.42	12.52	16.42
1975	13.93	16.66	13.93	16.66
1976	13.48	15.32	13.48	15.32
1977	14.53	15.61	14.53	15.61
1978	14.56	14.56	14.56	14.56
1979	21.54	19.80	21.54	19.80
1980	34.06	29.00	34.06	29.00
1981	37.08	28.85	37.08	28.85
1982	33.59	24.67	33.59	24.67
1983	29.35	20.78	29.35	20.78
1984	28.87	19.41	28.87	19.41
1985	27.11	17.28	27.11	17.28
1986	23.34	14.10	18.00	10.87
1987	21.07	12.06	16.64	9.53
1988	20.07	10.90	17.48	9.49
1989	23.52	12.10	35.47	18.25
1990	44.03	21.47	64.16	31.29
1991	71.21	32.92	81.67	37.76
1992	87.06	38.33	87.40	38.47
1993	95.39	40.00	88.77	37.22
1994	96.28	38.44	86.17	34.41
1995	91.69	34.87	79.52	30.25

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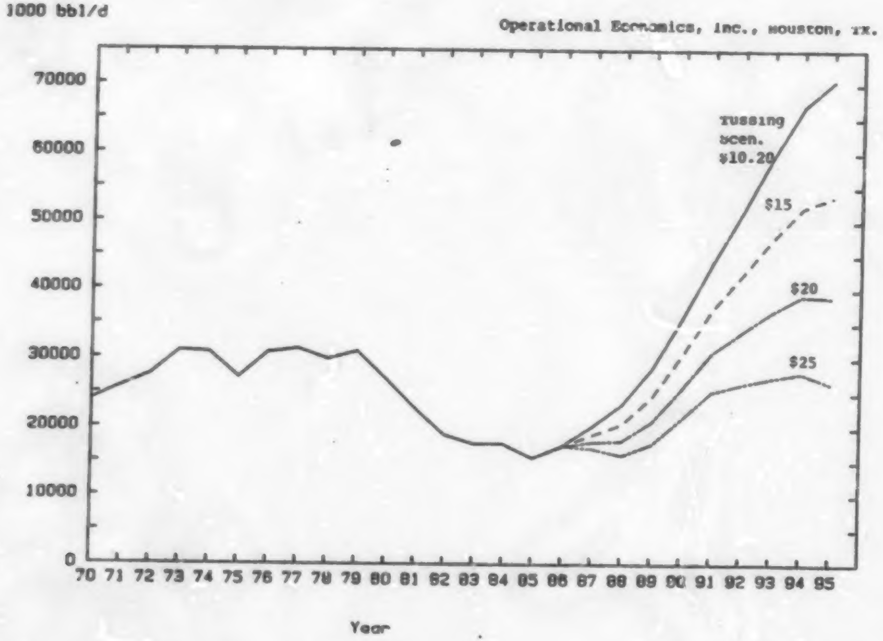
Figure 6.1.

OPEC Production for Four Arbitrary Price Scenarios
All Prices in 1978 Dollars Fixed at Levels Indicated After 1985



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stall in economic growth. For principle, see L. G. Thompson and M. D. George, "A Stochastic Investment Model for a Survival Conscious Firm," Annals of Operations Research, 2 (1985) 157-162.

Increasing uncertainty will emanate from the world oil market to the market economies of the Free World. Government intervention in the world oil market will be necessary to dampen the cycles, lengthen the periods and diminish the price/income uncertainty. Leadership in policy-making by the U.S. is urgently needed to correct an increasingly unstable market phenomenon.

7. Summary and Conclusions

In accordance with the leading energy experts cited in the Introduction, low oil prices and the current oil glut are definitely short-term transitory factors as found in OPCON's modeling analysis. The resulting acceleration in oil demand, because of not only low prices but also higher real economic growth, complemented by the slowdown in Non-OPEC production will come back to haunt consumers in the early 1990's. World oil prices will then reach previously unprecedented levels, which will be followed by a sharp slowdown in real economic growth around the world.

Cycles in oil prices will be of ever-increasing amplitudes and ever-decreasing period lengths, barring government intervention. Imposition of an oil import tax-type policy instrument is necessary to dampen these cycles and increase their periods.

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THE WORST ENERGY TAX

by Ernest J. Oppenheimer Ph.D.

Introduction. A tax on oil imports would have very harmful consequences for the U.S. economy. It would undermine the domestic petroleum industry and jeopardize its independence. It would saddle consumers with significantly higher energy bills. The effort to improve U.S. competitiveness in world markets would be dealt a severe blow. U.S. economic and political relations with many countries would be endangered. It is no exaggeration to say that such a levy would be the worst energy tax that could be enacted.

An oil import tax poses serious threats to the domestic petroleum industry. The imposition of a tax on imported oil is a disguised scheme for raising prices of domestic petroleum products. This procedure gives the illusion of benefiting domestic producers of oil and gas. In reality, most of their gains would be taxed away and the economy as a whole would be severely damaged. The economic distortions that would follow in the wake of an oil import tax would undermine the domestic petroleum industry, which could end up as a ward of the federal government.

Let us assume that the federal government levies a tax of $10 per barrel on imported oil. Such a tax would yield the U.S. Treasury $17.5 billion annually on the 4.8 million barrels of oil and petroleum products a day being imported. Domestic production of oil and natural gas amounts to about 18 million barrels daily, or 3.75 times as much as oil imports. Because the price of domestic oil and gas would rise in line with the import tax, gross gains to domestic petroleum producers would total about

$63 billion. Energy consumers and their political allies would launch a major drive to tax away most of these gains. This realistic view is expressed in an editorial entitled "Industry Should Seek Sound U.S. Energy Policy, Not Oil Import Levy" by the Oil & Gas Journal (September 16, 1985): "An oil import fee is an energy consumption tax in disguise. It might provide some momentary price strength for domestic production, which is why some producers--including many who would violently oppose a direct energy tax--support it. The price relief, however, would be quickly taxed away when lawmakers heard from constituents angry about the spurt in gasoline and heating oil prices."

Even if domestic producers are left with some of the gains, they would pay a high price for their dependence on the government. The magnitude of this federal intervention in the petroleum business would lead to an ever-widening role for the government at the expense of the private sector. Like agriculture, petroleum would increasingly become a ward of the government, with major decisions about production and imports geared to government policies. The experience with agriculture shows that under those conditions petroleum is likely to become a chronically sick industry.

This evaluation is not far-fetched. An oil import tax is a disguised form of government price support for domestic oil and gas. It will favor high-cost, inefficient producers at the expense of low-cost, efficient ones. It will lead to an ever deepening spiral of government involvement in the energy business. Such a development would pose a serious threat, not only to the petroleum industry, but also to the whole economy. Oil and natural gas constitute about three quarters of all the energy consumed in the U.S. For most manufacturing operations, energy expenses rank near the top of all costs. An inefficient petroleum industry, weakened by government controls, would undermine the competitive position of U.S. manufacturers at home and abroad.

Most U.S. oil and gas producers oppose government interference in their business via an oil import tax. They have the know-how and flexibility to adapt to a great variety of conditions, including lower oil prices. They deserve help in the form of fair tax treatment, which takes into account the high-risk nature of their business. They are economic realists and proud of their independence. They know and fear the high cost of government intervention in their business.

Adverse effects on international oil companies. An oil import tax would be very disruptive to the operations of international oil companies, which have invested many billions of dollars worldwide to produce oil in the most cost-effective manner. Everyone benefits from this policy, including consumers, the producing nations, and the oil companies. An oil import tax would undermine efficient operations and would jeopardize investments in oil production abroad. For example, a substantial amount of oil in Canada and Great Britain (North Sea) is produced by U.S. companies and transported to U.S. markets. These operations would be threatened by an oil import tax.

The pitfalls of such a tax were described by Michael E. Canes, Chief Economist of the American Petroleum Institute, in a letter to the Wall Street Journal (January 7, 1986). Mr. Canes states "The American Petroleum Institute has long opposed oil import fees. New oil taxes would be bad policy regardless of whether the owners of domestic oil resources retained a portion of any tax-induced price increases." It is noteworthy that members of the American Petroleum Institute produce most of the oil and gas in the U.S. They also have sizeable international operations.

An oil import tax would harm consumers. The prices of petroleum products and natural gas would rise by about $80 billion a year as a result of a $10 per barrel oil import tax. A price increase of this magnitude would be highly disruptive to the U.S. economy. It would deprive consumers of most or all the benefits from lower world oil prices. U.S. manufacturers and farmers, whose competitive position is already weak in international markets, would be dealt a devastating blow by higher energy costs.

For the past thirteen years, consumers have experienced great financial and economic hardship as a result of energy price escalations. Basic industries heavily dependent on energy, such as steel, metals, chemicals, paper, containers, and glass, as well as many manufacturing enterprises, were hit hard by high energy costs. States situated in the eastern and midwestern sections of the country experienced particularly severe consequences. Now that relief is in sight after all these years of misery, an oil import tax would deprive consumers of most benefits from lower prices. No one cam blame consumers for putting up strong opposition to such a tax.

The reduction of U.S. foreign trade deficits, which amounted to almost $150 billion in 1985, is a top priority national objective. An oil import tax would make U.S. manufacturers and farmers even less competitive in world markets than is currently the case. No other country would be foolish enough to impose a tax on oil imports. Foreign manufacturers would enjoy the benefits of lower energy costs, while U.S. exporters would be hamstrung by energy expenses that could not be passed on via higher prices. This perspective was expressed by Warren Anderson, Chairman of Union Carbide, in a letter to President Reagan: "Any oil import tax would hand to our overseas competitors a gift-wrapped price advantage" (quoted in a Wall Street Journal editorial "Dead on Arrival," February 6, 1986).

Oil import tax endangers U.S. relations with oil producing nations. In 1985, the U.S. was importing oil and petroleum products at the rate of 4.8 million barrels a day. According to the Monthly Energy Review, published by the Energy Information Administration, these imports came from the following sources (numbers in parentheses refer to thousands of barrels a day):

(1) Imports from nations in which U.S. oil companies have large investments in oil productions and/or refining. Canada (747), Great Britain (303), the Virgin Islands (230), Trinidad (121), the Antilles (40), and the Bahamas (37) fall into this category. In 1985, they supplied about 1.5 million barrels of oil and petroleum products daily, or almost one-third of all such imports. Canada and Great Britain are the most important political allies and trading partners of the U.S. It seems senseless to jeopardize U.S. relations with these countries by imposing a tax on their petroleum exports to this country. It is likely that they would take retaliatory measures agaist such a discriminatory tax. The Caribbean islands need all the help they can get. To deprive them of income from oil and refining operations would go counter to U.S. foreign policy.

(2) Imports from developing countries in Latin America and elsewhere. Mexico (833), Venezuela (576), Indonesia (303), and Nigeria (271) are the largest suppliers in this category. In 1985, developing countries supplied about half of U.S. oil imports. Most of these countries are heavily

indebted to U.S. banks. Income from oil exports is essential for debt servicing and for continuation of development programs. A discriminatory oil import tax would place these countries into an untenable position. Their predicament could lead to default on loans, which could endanger the solvency of some major U.S. banks.

(3) Imports from countries situated on the Arabian Peninsula, including Saudi Arabia (75), the United Arab Emirates (53), and Kuwait. As the data indicate, these countries supplied a negligible amount of U.S. oil imports in 1985. However, they are very important in world markets and as future sources of oil for the U.S. They have the world's largest proven petroleum reserves. These countries have long-standing close relations with U.S. oil companies and with the U.S. government. An oil import tax would harm U.S. relations with these nations.

Artificial oil price supports go counter to economic realities. The oil price declines in the 1980's are merely offsetting some of the increases that occurred in the 1970's. The market is saying that the more than tenfold increase in oil prices between 1973 and 1979 does not reflect current realities of demand and supply. Intervention by the federal government to prop up oil prices against these economic realities, which are fundamental and worldwide in scope, would be futile and highly injurious to U.S. interests.

Summary. To sum up, an oil import tax would be a costly and dangerous blunder. It would weaken the efficiency and independence of the domestic petroleum industry. It would arouse the ire of consumers, who would be forced to pay $8 billion in higher energy prices annually for each $1 per barrel oil import tax. It would cost U.S. manufacturers and farmers billions of dollars in lost sales on world markets. It would probably trigger retaliatory trade restrictions by oil exporting nations and defaults on loans by developing countries. It would be a futile attempt by the federal government to counteract economic forces beyond its control. This worst of all energy taxes deserves a decisive rejection by the American people and by their representatives in government.

(This article is a chapter from the author's forthcoming book Solving the U.S. Energy Problem--Revised Edition).

About the author. Ernest J. Oppenheimer is a social scientist and professional writer. He has done extensive research on energy and other national problems and has published the following books:

The Inflation Swindle.

A Realistic Approach to U.S. Energy Independence.

Natural Gas: The New Energy Leader.

Solving the U.S. Energy Problem.

Prior to his writing career, Dr. Oppenheimer spent fifteen years doing research and consulting in the investment banking field. He received the doctor of philosophy degree in international relations from the University of Chicago.

QUESTIONS AND ANSWERS

(1) Wouldn't an oil import tax encourage energy conservation?

Answer: An oil import tax and the resultant domestic energy price increases are unsound procedures for inducing conservation. It hardly makes economic sense to pnealize the whole economy with artificially high energy prices in order to reduce consumption. It would be far more sensible to follow the example of Western Europe and Japan, where governments impose substantial taxes on gasoline to raise revenues. This policy cushions the adverse effects of oil price escalations on the rest of the economy and allows the manufacturing sector to benefit fully from lower energy prices when they occur.

(2) Why is a gasoline tax better than an oil import tax?

Answer: A tax on gasoline has the following advantages over an oil import tax:

(a) It would focus on reducing wasteful use of energy in the vehicular sector, where the most effective results can be achieved at the least cost to the general economy. In contrast, an oil import tax would harm the whole economy.

(b) A gasoline tax would avoid the risk of offending U.S. trading partners and oil exporting nations. Virtually all other industrial countries already have gasoline taxes of $1 or more per gallon. They could hardly object to a rise in the U.S. federal gasoline tax, which is currently nine cents a gallon. A gasoline tax is a domestic matter and does not single our oil imports for negative treatment. In contrast, a levy on imported oil discriminates against foreign producers.

(c) The replacement of gas-guzzling vehicles with fuel-efficient ones has been going on for several years as a result of high gasoline prices.

This process would be continued by a gasoline tax increase. The impact of such a tax on the oil industry is indirect, gradual, and not disruptive.

In contrast an oil import tax would have direct, precipitous, and cataclysmic consequences for the international oil business. Many U.S. petroleum companies would have to restructure their operations, at enormous expense, to cope with an oil import tax.

(d) All of the proceeds from a gasoline tax would go to the U.S. Treasury. These funds could be used primarily to reduce federal budget deficits, which would result in lower interest rates, lessened inflationary pressures, and a more wholesome general economy.

In contrast, the petroleum price increases that would follow in the wake of an oil import tax would yield benefits to domestic oil and gas producers at the expense of the general public. Energy consumers, who would have to pay both the tax and the price increases, would consider themselves treated unfairly.

To sum up, a levy on gasoline is the best energy tax that could be devised, while a tax on oil imports is the worst.

For a more comprehensive treatment of a gasoline tax proposal, the reader is referred to my study "Spending Cuts and Gasoline Tax to Solve U.S. Economic Problems."

(3) Do you have any suggestions for helping domestic petroleum producers cope with low oil prices?

Answer: The federal government should remove restrictive legislation that harms the domestic petroleum industry. The windfall profit tax on oil should be abolished. The Fuel Use Act restrictions on oil and natural gas no longer serve a useful purpose and should be eliminated. Consideration should be given to making lease and royalty terms for domestic producers on federal properties more attractive in line with new market realities. Equally important, tax changes that would adversely affect domestic oil and gas producers should be avoided. The domestic petroleum industry should not be made into a sacrificial lamb on the altar of tax reform.

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Statement
by
Robert G. Reed
Chairman and Chief Executive Officer
Pacific Resources, Inc.

Before the
Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation

February 27-28, 1986

Good morning, Mr. Chairman and Members of the Committee. It is a pleasure to appear before you today to discuss the possible imposition of an oil import fee - a fee we strongly oppose.

I am Robert G. Reed, the Chairman and Chief Executive Officer of Pacific Resources, Inc. Pacific Resources is a Hawaii-based independent energy company with subsidiaries and activities located in Hawai, Los Angeles and Houston, in the Pacific Islands, and in Asia. Our interests include oil refining and trading, marketing and distribution of petroleum products, gas utility and propane service, and alternate energy products. We are unique in that we are the United States' farthest west refinery. This location in the mid-Pacific dictates that after we serve the Hawaiian market, we must look west from Hawaii to sell our products and seek expansion.

We, therefore, need to compete in the export market. We are so used to thinking in terms of the domestic market and the U. S. and foreign operations that affect it, we often forget that we, too, can participate in international petroleum marketing operations. Obviously, if we are to be competitive against foreign companies in the international arena, the U.S. government must provide us an appropriate atmosphere in which to operate. We are responsible for developing the markets, the quality products, and the efficient operations which allow us to operate successfully. And we have done so. In turn, it is government's responsibility not to interfere with the marketplace to the extent that it deprives us and our shareholders of the opportunity to compete. The imposition of an import fee does precisely that.

Let me elaborate. Pacific Resources obtains approximately 50% of its crude supply from domestic sources. After serving the Hawaiian market, our remaining products are moved into foreign commerce. If an import fee is imposed, everyone agrees that the price of domestic crude will rise to a level near the combined price of free market crude and the fee. Since we compete against foreign companies who obtain their crude without regard to an import fee, we are immediately put at a price disadvantage. As you well know, when you are competing in the open market, it is difficult to maintain market share when you are at a price disadvantage. What makes this especially exasperating is the fact that the price disadvantage would not be a function of the market or management inefficiency, but government fiat. We know that given an opportunity to compete against non-U.S. export refiners we can do so, and do so well. But we cannot hope to succeed if our government burdens us with an import fee.

We are not the only ones opposed to an import fee. Testimony already received by the Finance Committee elicited comments from several well-known economists opposing the fee. Their reasons ranged over the entire economic spectrum from worsening the U.S. competitive position (our objection) to affecting the strength of the dollar. The Consumer Federation of America suggests that a $10 import fee would result in the loss of 500,000 jobs to foreign competition. The National Association of Manufacturers calculates that a $5 per barrel tariff would raise the Consumer Price Index by 0.5 to 1.0 percentage points. Both the Wall Street Journal and the Washington Post, two papers which often disagree on business issues, have published editorials in opposition to the import fee. In general, the range of opposition to the fee is surprisingly wide. Consumers, academicians, politicians, the President, major trade associations, including the Independent Producers Association of America and the American Petroleum

Institute, large and small corporations, and entire geographic sections of the United States oppose the fee. Those in favor of the fee are limited to people or groups who view it as saving something for themselves. A report in the January 30th issue of B.N.A.'s Energy Report suggests that the U.S. Conference of Mayors, for example, is considering an import fee or gasoline tax, not as a national policy item, but rather because they believe that the additional revenues will preserve Federal spending programs important to them. In fact, the only support for a fee apparently comes from those who see something in it for themselves - hardly national policy, only 'self' policy. We advocate a free and open market in which to compete. When we visit Capitol Hill we are constantly reminded that we should more readily adapt to competition and not look to the government to solve all our problems. We agree. Now, in reverse, we hope that the Government does not decide to eliminate competition to solve its problems.

What makes the imposition of an import fee on independent export refineries especially difficult to accept is the fact that we have recently come through a very difficult period or "shakeout" as a result of the end of the notorious entitlements era. There were many cries to Congress to provide relief for these refiners and several hearings were held on the impact of their loss on the United States. Importantly, no action was taken to relieve their distress. What has resulted in the industry, I believe, is a healthier, leaner, more efficient refiner who is better able to compete against the large integrated companies, and in our case, large multinationals. In other words, the industry was told to let the free market operate and it did. Now that this "shakeout" period is over and we are prepared to compete, actions by the government may accomplish what open, honest competition could not. This is a disturbing premise.

We do not and can not ignore the reasons which give rise to desires to impose an import fee. We too are concerned about the deficit and tax reform, but we do not agree that these problems require the government to take actions which clearly inhibit private and publicly held companies from carrying on legitimate business. The role of government does not require it to act in this manner. There are many ways to resolve the revenue problems which give rise to the fee. We support the concept of a gasoline tax, for instance. It falls on all segments of society and includes their active participation in the deficit solution. Other solutions to the deficit problem can be found. They may not necessarily be easy, but certainly would not interfere in the competitive marketplace - as does the import fee.

In summary, we appear before you today to say that the imposition of an import fee has a decidedly negative impact on our ability to compete in the international marketplace. It affects free and open competition. It negatively impacts foreign trade opportunities both in terms of markets and the trade deficit. We ask you not to go forward with the fee. If you are compelled to do so, we want you to be cognizant of the problems of the export refiner and respectfully request that you work toward legislation which does not restrict our ability to compete. You must give exports attributable to domestic crude some relief from any increase in domestic crude prices resulting from a fee.

PETROLEOS MEXICANOS

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February 27, 1986

The Honorable Malcolm Wallop
Chairman
Subcommittee on Energy and
  Agricultural Taxation
Committee on Finance
United States Senate
Washington, D. C. 20510

Re: S. 1507 and S. 1997, regarding Oil Import Fees

Dear Mr. Chairman:

As General Representative of Petroleos Mexicanos ("Pemex"), I appreciate being given this opportunity to comment on the oil import fee legislation being considered by the Subcommittee on Energy and Agricultural Taxation. My comments will discuss potential adverse effects of the proposed oil import fees, addressing the impacts on Mexico and Pemex. I respectfully ask that these comments be included in the record of the Subcommittee hearings being held on this issue.

Let me state my understanding of these bills. S. 1507, sponsored by Senators Boren and Bentsen, would impose an oil import fee of $5 per barrel on crude oil and $10 per barrel on petroleum products. The Bill would take the form of an increase in the tariffs on petroleum under the Tariff Schedules of the United States. The Bill would exempt home heating oil and uses of petroleum which are necessary and inherent to the manufacturing process for products destined for export. The crude oil fee would begin to phase out when world oil prices reached $25 per barrel and would end at $30. S. 1997, sponsored by Senators Wallop and Bentsen, would impose an oil import fee (on crude oil and products) designed to maintain a $22 per barrel domestic "energy policy price" of crude oil plus an extra $3 per barrel fee for product (called an "environmental outlay adjustment"). For example, if the world oil price were $20 and the energy policy price were $22 the crude oil excise fee would be $2 and the product fee $5. The Bill would take the form of an excise tax, on imports only, amending the Internal Revenue Code. Both fees would be increased for inflation in proportion to changes in the GNP per capita.

In my capacity as General Representative of Pemex in the United States, I urge that import fees not be imposed. Oil import fees will hurt both the American and Mexican economies. Each country is a major trading partner of the other and, because of that interdependence, the damage which the proposed oil import fees would cause to the American economy would, in turn, adversely affect the Mexican economy even if Mexico did not export oil.

However, Mexico would be especially hurt by the proposed legislation since Mexico relies on oil exports for about 75% of its foreign exchange revenues. Continuing access to United States markets for Mexican oil is essential for the Mexican economy. Oil export revenues are essential to Mexico's ability to

- purchase imports from the United States,
- manage our debts to the United States and
- meet the needs of a populous developing country.

Oil import fees, coming on the heels of declining world oil prices, would intensify the already acute foreign exchange problem Mexico faces, to the detriment of both Mexico and the United States.

Pemex

Pemex is the public decentralized organism of the Mexican Federal Government charged with the development of Mexico's hydrocarbon resources. It is therefore the sole producer and seller in Mexico of crude oil. It is also the only Mexican producer and seller in Mexico of various down-stream petroleum or petrochemical products, such as gasoline and distillate heating oil. This Pemex role results from Article 27 of the Mexican Constitution of 1917, according to which all ownership and administration of Mexico's hydrocarbon resources reside in the State.

The United States is the principal destination for Pemex oil exports and, since 1982, Pemex has been the largest supplier of oil to the United States. Pemex supplies almost 20% of all crude oil imports to the United States and about 6% of all crude oil used by American refiners. During some months, Pemex sales of crude oil and products to the American market have exceeded 800,000 barrels per day. Pemex sells oil at competitive market prices. Pemex itself also imports petrochemicals, equipment and spare parts from the United States.

A. Oil import fees would hurt the American economy, thereby hurting Mexico, and would undermine stability of American energy policy

The United States has tried and rejected oil import fees before. Reimposing oil import fees would increase prices, raise input costs of American industries, and slow the American economy.

The injury to the American economy as a whole would be substantial because oil import fees would raise the price of all oil in the United States, domestic as well as imported, and might well push up prices of other domestic fuels as well, while fuel prices in Europe, Asia, and other economies would decline (due to decreased U.S. consumption caused by higher U.S. prices). Although American oil producers and refiners would benefit from only about two-thirds of the amount of an import fee, as I will later explain (in C. below), American energy consumers would suffer the entire detriment of the fee.

Reimposition of oil import fees would also cast doubt upon the stability of American energy policies. As a principal supplier of imported oil for the American market, Pemex has a vital stake in such stability.

American oil import fees were suggested as an alternative to import quotas in 1970 by a Cabinet Task Force chaired by George Shultz, then Secretary of Labor. Fee-paid import licenses, with gradually-diminishing exemptions and escalating fees (up to 21¢ per barrel of crude oil and 63¢ per barrel of product), were imposed by President Nixon in 1973; however, the exemptions deferred the practical impact of the fees. In 1975, President Ford imposed much higher supplemental fees (of $1 per barrel escalating to $2 and then $3). Although these fees were sustained by the Supreme Court, *FEA v. Algonquin SNG, Inc.*, 426 U.S. 548 (1976), and went into effect, President Ford rescinded them in 1976, restoring President Nixon's fees and timetable. These were suspended by President Carter in 1979 just when they might have become fully effective. Then in 1980 President Carter proclaimed a new oil import fee, to be passed on only to gasoline, which was struck down by the United States District Court. *Independent Gasoline Marketers Council, Inc. v. Duncan*, 492 F.Supp. 614 (D. Ct. D.C. 1980). President Reagan revoked the license requirement to which oil import fees had been tied.

For the past five years, the principal thrust of American energy policy has been deregulation, to the benefit of the American economy. For Congress to reimpose oil import fees now would raise the spectre of renewed twistings and turnings, policy reversals and regulatory complications.[1] Experience suggests that policy insecurity will dilute much of the benefit proponents hope to achieve for domestic producers.

B. Oil import fees would set back efforts to expand free trade and would stimulate protectionism

The United States has embarked on a significant effort to achieve genuinely freer trade with all of its trading partners in Europe, Asia and the Americas. For the United States itself to adopt oil import fees would fly in the face of that effort, reinforcing resistance to more open markets for American exports.

Similarly, American industries would be stimulated to seek new protections. As a result of oil import fees, American industries would feel themselves at a competitive disadvantage both in exporting to the world and in meeting imports and would press for import protection to compensate for the higher costs imposed by the import fee.

The Subcommittee is considering these oil import fee proposals just at the time when Mexico has agreed to negotiate to join the GATT and to enter into additional bilateral trade negotiations with the United States, following up Mexico's liberalization of trade regulations last year. Enactment of these bills at this time would impair efforts toward further progress in trade relations and might be adverse to these positive steps.

The United States and Mexico need one another. Our two countries trade in many commodities and finished products. The United States is Mexico's largest supplier and largest customer and Mexico is the fourth largest market for the United States. Disruption of that trade through an oil import fee would have an adverse impact on both the United States and the Mexican economy.

1/ For example, it is likely that industrial users of oil and its derivatives will seek exemption from (or a bureaucratic system of rebates of) the import fee to the extent that they export products (such as petrochemicals) made from oil. The same logic would apply to users of domestic oil as to users of foreign oil, although the relief may differ. Sorting out the claims of the American exporters may lead to the restoration of a network of oil price rules and regulations.

C. An oil import fee would further depress Mexico's oil prices

An oil import fee would further depress the prices Mexico receives for its oil exports. An oil import fee would set a price differential between oil inside the United States and oil on the world market equal to the amount of the fee. That differential would not come about entirely by raising the American domestic price. In part, the fee would lower the world market price. For example, assume a fee of $6 per barrel. United States consumption is about 15 million barrels a day and consumption in the other market-economy countries is about twice as much, or 30 million barrels a day. If the short-run price elasticity is roughly equal in both areas (say, as low as 0.1) then the effect of the import fee would be divided inversely to the 2:1 proportion of consumption: 2/3 to the U.S. market and 1/3 to the rest of the market. If, then, the hypothetical $6 fee added $4 in the U.S. to an assumed pre-fee price level of $16 (that having been both the U.S. and world price level), it would bring the U.S. price up to $20. That 25% price increase would reduce U.S. consumption by 2.5% (= 0.1 x 25%) or 375,000 barrels a day. A $2 drop in the world price would come about so as to increase consumption in the rest of the world by 1.25% to absorb the 375,000 barrels per day (= 30 million barrels a day x $2/$16 x 0.1) which were added to non-United States supplies as a result of the decrease in United States consumption.

A $2 per barrel drop in the world oil price, which is what Mexico would receive for all of its exports, would amount to a cut of about 14% in terms of mid-February 1986 price levels for Mayan crude, Mexico's predominant export grade.[2]

D. Proposed oil import fees would discriminate against Mexican oil

The two pending bills establish flat import fees that apply equally to all crude oils. Crude oil is not a homogenous commodity. Indeed, United States refiners have spent billions of dollars to upgrade refineries to be able to take a variety of crude oils, including low quality crude oils. It costs more to turn low value crudes than high value crudes into gasoline and other marketable products. (For example, it may take twice as much energy to refine one crude as another.)

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[2] Moreover, under S. 1997, that $2 cut in the world price would lead to a further cut by raising the import fee.

The marketplace takes account of value differentials, pricing Pemex's predominant Mayan crude, for example, at significantly less per barrel than the price of its Isthmus crude, while placing a premium on high value crudes, such as Libya's.

A flat import fee does not take account of value and thus discriminates against below-average crude oils (and against refiners that invested to be able to handle such crudes). Pemex's mix of crude oils is of a lower value, on the average, than the mix of most other exporting countries. Thus, the proposed flat crude oil import fees of so many dollars per barrel -- without regard to value -- would penalize Mexico as compared with most other countries with higher value crudes. Indeed this import fee would depress the relative values of all low value crudes (whether produced in Mexico or California) and enhance the relative worldwide value of all high value crudes (whether produced in Libya or Louisiana). This discrimination would parallel what happened to California heavy oil during the last episode of United States oil pricing regulations.[3] A flat import fee would depress the value of California heavy oil (and other low-value domestic crude oils) relative to high value domestic crude oils.

E. Proposed oil import fees disregard the reliability of Mexican oil

The United States economy needs imported oil. The United States does not produce enough oil to meet its needs and has no plan for doing so. Strategically, immediate neighbors are the most secure source of supply. The Cabinet Task Force on Oil Import Control so concluded in 1970. Mexico offers a reliable and economic source of supply on which the United States can rely. The United States benefits from, and should therefore not wish to discourage, oil imports from Mexico.

Mexico needs marketing security in order to maintain the capability of supplying oil for all the varied needs of the United States. The U.S. has had every reason to encourage Mexico to develop Mexican oil resources. It would be counter-productive now to impede Mexico's oil exports to the United States.

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[3] Then a flat dollars-per-barrel entitlement requirement so depressed the value of the heavy oil to refiners that production was shut in during a period of oil shortages.

As the Subcommittee considers this legislation, I urge you to weigh not only immediate circumstances that have prompted these legislative proposals but also the likely adverse effects of the proposed fees on long-term trade and strategic interests.

In conclusion, let me again express my appreciation for being permitted to share Pemex's concerns with the Subcommittee. Please let me know if there are any points on which you would wish me to augment these comments.

Sincerely,

PETROLEOS MEXICANOS

Alfredo Gutierrez Kirchner
General Representative

STATEMENT OF THE
PETROLEUM MARKETERS ASSOCIATION OF AMERICA

BEFORE THE

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

ON

AN OIL IMPORT TAX

February 28, 1986

The Petroleum Marketers Association of America (PMAA), formerly the National Oil Jobbers Council (NOJC), is a federation of 41 state and regional associations representing some 11,000 independent marketers of a wide range of petroleum products including gasoline, home heating oil, and diesel fuel. Collectively, the marketers represented by PMAA sell approximately 50 percent of the gasoline and 80 percent of the home heating oil consumed in America. Although virtually all the marketers PMAA represents are small businessmen, their collective assets rank them 17th on Fortune 500's list of companies ranked by assets.

Together these businessmen directly employ over 239,000 persons and as local businessmen serve the energy needs of millions of ordinary Americans. This being the case, we are especially aware of the implications of various oil import tax proposals, which are now being considered.

Numerous reasons have been put forth in favor of an oil import tax. Among other reasons, it is seen as a means to strengthen national security. Others believe that it will weaken OPEC. Others believe it is necessary to protect our domestic production industry. Still others want the tax as a means of reducing the federal deficit. Finally some think it is the ideal source for the lost revenue from tax reform. This is a far cry from the days when Americans were told that rising oil prices were the purveyor of inflation, high interest rates, unemployment and a general reduction in our standard of living and Americans were being urged to conserve as a means of reducing America's dependence on foreign crude.

An oil import tax is bad energy policy, bad tax policy, bad economic policy, and certainly bad trade policy. If it were the panacea to the nation's ills as many would have us believe, it would have been enacted long ago. However, due to the overly simplistic appeal of an oil import tax it has become like the proverbial bad penny, always turning up as the solution to whatever problem exists.

HISTORICAL PERSPECTIVE

One thing that history has taught us is that as oil prices move, so does the nation. When oil prices are rising, inflation and unemployment are on the increase and economic activity on the decline. When oil prices fall, inflation and unemployment decline, and economic activity grows. It has not been that long ago that history offered us the perfect example.

Beginning in 1973, the Arab oil embargo and subsequent monopolistic pricing by OPEC nations, sent prices of crude oil soaring. From 1973 to 1974 the price of oil imported to this country rose from $4.08 to $12.52 per barrel, an increase of over 300 percent. This came at a time when domestic production was at near record levels of 9.4 million barrels per day and imports of crude oil were 3.2 million barrels a day. Foreign crude oil prices began to drive domestic crude prices, and as can be seen from Table 1 oil prices continued their upward progression until 1981.

TABLE 1
US REFINER ACQUISITION COST OF CRUDE OIL
(dollars per barrel)

Year(1)	Domestic	Imported	Composite
1968	3.21	2.90	3.17
1969	3.37	2.80	3.29
1970	3.46	2.96	3.40
1971	3.68	3.17	3.60
1972	3.67	3.22	3.58
1973	4.17	4.08	4.15
1974	7.18	12.52	9.07
1975	8.39	13.93	10.38
1976	8.84	13.48	10.89
1977	9.55	14.53	11.96
1978	10.61	14.57	12.46
1979	14.27	21.67	17.72
1980	24.23	33.89	28.07
1981	34.33	37.05	35.24
1982	31.22	33.55	31.87
1983	28.87	29.30	28.99
1984	28.53	28.88	28.63
1985			

(1) Prices unavailable prior to 1968.
Source: U.S. Department of Energy: Annual Energy Review

As a result of this dramatic crude oil price spiral our economy suffered dramatically. Memories of the long gasoline lines, high unemployment and soaring inflation are not so distant that they can not be recalled. Interest rates close to twenty percent are a sad, but all too recent memory. Rapidly rising oil prices in an economy founded and growing on inexpensive energy sent shock waves throughout the economy, many of which are still being felt.

PMAA is well aware of the current arguments being advanced for an oil import tax. We still find them unpersuasive and would appreciate the opportunity to address each one individually.

National Security and an Oil Import Tax

The argument that an oil import tax is needed as a means to ensure national security is not new. Oil is important to national security both in terms of its availability and its impact on economic activities. The proponents of an oil import tax from a national security perspective have argued that such a tax is necessary because: (1) it discourages consumption and thereby places less reliance upon unstable foreign, particularly OPEC, crude oil; (2) it raises domestic prices and encourages exploration for crude oil here, thereby reducing our future dependence upon foreign oil; and (3) it protects our nation against supply disruption by assuring an adequate supply in the United States.

Many of these arguments have been used before. But, history shows that artificial import restrictions did not have the desired effect.

The Eisenhower Administration imposed the Mandatory Oil Imports Program (MOIP) in 1959 which restricted the amount of foreign oil imported into this country. The result was to raise the domestic price of crude oil relative to the world price. Table 2 illustrates the impact of MOIP on the relative price of domestic and foreign crude oil.

TABLE 2
US REFINER ACQUISITION COST OF CRUDE OIL
(dollars per barrel)

Year(1)	Domestic	Imported
1968	3.21	2.90
1969	3.37	2.80
1970	3.46	2.96
1971	3.68	3.17
1972	3.67	3.22
1973	4.17	4.08

(1) prices unavailable prior to 1968
Source: U.S. Department of Energy: Annual Energy Review.

This policy encouraged the consumption of higher priced domestic oil when foreign oil was cheaper. Further, it resulted in the massive transfer of income from American citizens to domestic producers. It also resulted in lower exports and higher inflation and unemployment than would have occurred in the absence of the quotas.

In spite of the protection afforded domestic producers, the American economy was not sheltered during the 1973-74 and 1978-79 oil supply disruptions, when rising crude oil prices threatened our economic well being.

We know from experience that America is not oil self-sufficient. We must import part of our oil needs. That is a fact of life. Additionally, the level of imports is such that the price of imported oil determines domestic crude oil prices. Given that the bulk of U.S. onshore reserves have been discovered and offshore exploration is not projected to contribute significant amounts of crude oil reserves, imported prices will likely continue to determine domestic prices.

America has made a startling turnaround in its dependence of unstable foreign oil. U.S. dependence upon foreign oil peaked in 1977 when, according to the EIA, imports of crude oil constituted 45 percent of total crude oil supplied. Our dependence upon OPEC nations also peaked as they constituted 72.3 percent of net imports. Since that time we have become less dependent upon all foreign sources, and especially that from Arab-OPEC nations. Preliminary 1985 data show that crude oil imports accounted for only 26 percent of demand. Arab-OPEC countries accounted for only 8.7 percent of total petroleum imports while total OPEC imports were 35.5 percent of all imports.

The national security argument says that we must have in place the necessary domestic reserves and production capacity in the event of a national emergency and that under the current climate this can only be done by raising domestic prices. The argument continues that if oil prices continue to fall reserves will be shut in and domestic producers, who face higher production costs than Arab-OPEC nations, will stop producing. Additionally, it is argued that exploration will also fall as prices decline.

These arguments are only valid if the price of oil falls below U.S. production and exploration costs, and if the emergency occurs in the near future. The majority of domestic production costs are still well below the domestic price of oil. According to the EIA publication, "Performance Profiles of Major Energy Producers 1984", the domestic production cost for the major oil companies was $7.04 per barrel including production taxes and $3.80 per barrel after taxes. Petroleum discovery costs, according to this report, were $9.13 per barrel before taxes and $5.47 per barrel after taxes. The current price of oil is well above both the average exploration and production costs for the major oil companies. Table 3 presents the average finding and lifting costs and profit margins on oil production for these companies.

TABLE 3
BEFORE AND AFTER TAX REVENUE, COSTS, AND PROFIT MARGINS
FOR FRS COMPANIES, 1982-1984 (1984 DOLLARS PER BARREL)[a]

Revenues and Costs	1982	1983	1984
Revenue[b]			
Before Tax	14.14	22.88	22.36
After Tax	13.04	12.36	12.07
Finding Costs[c]			
Before Tax	14.75	10.65	9.13
After Tax	8.75	6.31	5.47
Lifting Costs[d]			
Before Tax	8.59	7.65	7.04
After Tax	4.64	4.13	3.80
Profit Margin[e]			
Before Tax	0.80	4.58	6.19
After Tax	-0.32	1.92	2.80

[a] All dollar values converted to 1984 dollars using the implicit GNP price deflator.

[b] Value of reserve additions at current year prices. Oil price is average FRS company production sales price of crude oil and NGL. Gas price is price on new gas (NGPA categories 102, 103, 108, and 109) from Energy Information Administration, Natural Gas Monthly, DOE/EIA-0130(85/08) (Washington, DC, October 1985), page 12.

[c] Based on Table 41

[d] Includes production taxes

[e] Revenue less finding and lifting costs.

Source: Performance Profiles of Major Energy Producers - 1984

As can be seen from Table 3 inflation adjusted profit margins for oil production has been increasing (even though crude oil prices have been falling). In addition, both inflation adjusted production and exploration costs have been falling. Even now oil companies can still make a profit and will continue to explore for oil.

Some oil companies claim that falling oil prices reduce significantly the incentive to search for oil. There are many factors associated with the decision to search for oil, not the least of which are the questionable business judgements of those companies that have participated in the merger mania. It is, however, the expectation of long run oil price trends that is responsible for exploration, not short run oil price movements, and the long run trend is going to be rising oil prices.

In summary, there are three fatal flaws to the national security argument. The first is that it does not recognize that domestic prices are set by foreign prices and this can be a source of great economic disruption, as was seen during 1973-74 when foreign oil prices began to rise rapidly. The second flaw is the failure to recognize the long term implications of a short term solution. If, through an oil import tax, we encourage the consumption of domestic oil relative to that of foreign oil now, present consumption will be greater and future reserves smaller. This "drain American first" policy would mean that we would run the risk of not having enough reserves and production to meet a future emergency. The third fatal flaw is that proponents have ignored the changing import patterns. America now relies on our traditional allies for the bulk of our crude oil, not those nations which cut us off during 1973-74.

National security is more likely to be threatened by a weak economy brought about by domestic oil prices being higher than world oil prices. This is precisely what an oil import tax will do. However, that point will be addressed later.

Import Taxes and Energy Policy:

The idea of an oil import tax as an energy policy is seriously flawed. This nation took a path toward neutrality and reliance on market forces when domestic oil markets were decontrolled by President Reagan in 1981. From 1959 to 1981 the federal government regulated oil markets in such a way as to influence our consumptive patterns. During part of this period government policy raised domestic prices above world prices and encouraged the consumption of higher priced domestic oil, when cheaper alternatives existed. From 1973 to 1981, the Crude Oil Entitlements Program encouraged the consumption of foreign crude and the transfer of large sums of American wealth to OPEC nations.

As outlined in the last Presidential National Energy Policy Plan, the goal of our nation regarding energy should be to promote a "mixed and balanced" energy resource system, such that all fuels compete on their own merits. This means that government intervention should strive not to alter the relative prices of fuels. An import tax will do just that by increasing the price of oil relative to that of other fuels and by favoring domestic crude oil over foreign crude oil. The net result is an energy policy designed to promote inefficiency.

There are other ways the government can induce exploration and production of crude oil. PMAA believes that the federal and state governments should encourage domestic oil activity. It can be done by reducing severance taxes on crude oil, by extending the oil depletion allowance, and through increasing the intangible drilling credits. We could adopt a system similar to the one the United Kingdom uses in the North Sea. Under this system a well's production is not taxed until all the exploration and development costs have been recovered by the company. These are just a few of the ways our domestic oil industry can be helped without hurting America.

TRADE POLICY

A number of the proponents of an oil import tax, see it as a trade policy that stimulates domestic output at the expense of other nations, and, at the same time, as a means of punishing OPEC for its past actions.

OPEC artifically raised the price of oil and now the argument goes that the U.S. can force it down below the levels it would normally attain without an import tax. This of course assumes that the incidence of the tax would fall partially or totally on the exporting country. Given the current state of world oil markets this is a plausible assumption.

It is true that an oil import tax would have to be absorbed to some degree by producing countries, and this would reduce OPEC revenues. However, OPEC is not the only group of countries from which we purchase crude oil. All nations exporting crude oil and refined products to this nation would be adversely impacted. Table 4 below presents U.S. imports by selected country or group of countries.

TABLE 4
IMPORTS OF CRUDE OIL AND REFINED PRODUCTS
BY SELECTED AREA OR COUNTRY
(000's BPD)

	ARAB OPEC	CANADA	MEXICO	TOTAL NON OPEC	TOTAL IMPORTS
1973	915	1,325	16	3,263	6,256
1974	752	1,070	8	2,832	6,112
1975	1,383	846	71	2,454	6,056
1976	2,424	599	87	2,247	7,313
1977	3,185	517	179	2,614	8,807
1978	2,963	467	318	2,613	8,363
1979	3,056	538	439	2,819	8,456
1980	2,551	455	533	2,609	6,909
1981	1,848	447	522	2,672	5,996
1982	854	482	685	2,968	5,113
1983	632	547	826	3,189	5,051
1984	819	630	748	3,388	5,381
1985	434	756	831	3,213	4,986

Source: November 1985 Monthly Energy Review

American hostility towards OPEC stems from the Arab embargo. It should be noted that Venezuela, founding member of OPEC, did not participate in the embargo. Venezuela was and is a loyal ally of America. Since Arab OPEC exports account for only about 9 percent of total imports a tax designed to hurt Arab OPEC nations or designed to lessen our dependence on those nations would certainly hurt many of our allies such as Mexico, Canada, the United Kingdom and others. An import fee applied unilaterally, will punish not only all nations but also the American banks which have lent those nations money. In the case of Mexico, this action would be disastrous to both Mexican and American banks.

For the reason that an unilateral import fee would punish American allies and banks, it has been proposed that the fee be restricted to specific countries. The immediate result would be a short term reduction in imports from affected countries. In the long run imports would shift from the affected countries to those countries not facing an import fee. This would have the impact of shifting the source of imports, but not seriously lessening our dependence on foreign sources of oil.

Moreover, exempting certain nations from an oil import tax could also have other negative effects. First, it will reduce substantially the level of revenue such a tax may generate. In fact, the revenue enhancement benefits of an import tax may be completely eroded if imports from those countries affected by a tax decline substantially and are replaced by imports from countries exempt from the tax.

Secondly, by exempting certain countries from the tax, domestic market distortions could occur leading the U.S. to the same position it was in during the 1970's including a reenactment of the entitlements program and the government regulatory bureaucracy that accompanied it.

An Oil Import Tax as a Protectionist Measure:

In the last year approximately 300 bills have been introduced in Congress to impose quotas, tariffs or some other form of protectionism. This can also be seen in the oil industry as industry trade groups and unions seek to protect themselves from foreign competition. The arguments against protectionism are all too familiar and, therefore, need not be repeated here. However, it is important to note the costs of protectionism. Two recent studies measure the costs and benefits from the Voluntary Export Restraint program that limited Japanese auto exports to this country. These studies "indicate that the cost per one job saved in the U.S. auto industry was between $160,000 and $183,000 per year."

An oil import tax would also have two very important impacts on the American manufacturing community. First, it would result in fewer dollars being spent abroad and this would work on raising the value of the dollar overseas. A rising dollar makes it more difficult for American manufacturers to compete in foreign markets, a problem already costing numerous Americans their jobs. Secondly, an oil import tax raises the costs of manufacturing in America by raising the price of energy in this country relative to other countries' energy prices. This makes imports cheaper, as does a rising dollar, and this will displace American jobs and profits.

An import tax can do nothing but raise the cost of producing goods in this country. It can protect American jobs in the oil industries, but only at the cost of many more jobs throughout the remainder of the economy. It will hurt our allies, damage our banks and destroy an already weak manufacturing sector.

Deficit Reduction and Tax Reform:

The last major source of support for an oil import fee comes from those seeing it as a source of revenue either to reduce the deficit or to offset other tax reductions which may be included in a revenue neutral tax reform bill.

Public concern over the large federal deficits has intensified with enactment to Gramm-Rudman-Hollings bill which mandates specific levels by which the federal deficit must be reduced. The recent decline in oil and associated refined product prices has spurred the desire of some lawmakers to seek to reduce the deficit by means of an oil import tax or gasoline excise tax increase.

There are factors which make an oil import tax an attractive source of new revenue. First, oil is a politically attractive target. Second, because oil prices are falling, it is believed that consumers and the economy will not notice the imposition of an import tax. Third, it is believed that the tax will help an ailing domestic oil industry and reduce our dependence upon foreign crude oil. Finally, it is believed that this is the best of other possible alternative means of reducing the deficit.

PMAA believes there are, however, numerous alternatives to an oil import tax as a means of reducing the deficit. Many of these are articulated in the President's budget proposal and center around reductions in federal spending. PMAA also believes that there are better alternatives to generating revenue than an oil import tax and we would be happy to discuss those if the Committee desires. However, to blindly call for an oil import tax without considering the macroeconomic impact of such a tax is ill advised.

First, declining oil prices actually reduce the federal deficit by lowering government outlays and increasing tax revenues. The Office of Management and Budget and the Congressional Budget Office first estimated the 1987 FY deficit to reach $200 billion; however, the impact of falling oil prices has caused them to reduce their estimates to between $178 and $182 billion. Falling oil prices since the beginning of 1986 have reduced the projected deficit by over $18 billion dollars. Projections of inflation and unemployment are also down and general economic activity increased.

Assuming that an oil import tax caused no ill side effects to the economy, it would require an import tax of $15.32 per barrel to raise this $18 billion. Things just are not that simple and an oil import fee will have serious, even disasterous effects on the economy.

Economic Implications of An Oil Import Fee

We begin by assuming that the government wants to raise revenues through a crude oil import tax. For the purpose of analysis a $10 per barrel tax will be considered. Several current proposals call for a tax this high. (For the time being, the imposition of a refined product import fee will be avoided. This only serves to cloud the discussion. Imposition of such a product tax would raise the estimates of inflation and unemployment and lower the level of economic activity associated with an import tax.)

An import tax changes the relative cost of oil and of commodities using oil as an input. The short term result is higher prices for commodities manufactured using oil in some form and higher refined product prices. This means higher energy prices, gasoline prices and higher prices for such items as plastics and petrochemicals. Next, both business and consumers shift away from the higher priced oil to other commodities. There is a reduction in real income and this coupled with higher prices lower aggregate demand results in a suboptimal growth path of Gross National Product, employment and increases the rate of inflation.

It is also important to briefly explain the manner in which an oil import tax impacts the economy. The imposition of a $10 per barrel import tax, at current crude oil price levels would result in:

- An increase in the domestic crude oil price by $10 per barrel.
- An increased crude oil bill of $121.4 million per day.
- This increased price of imports forces down consumption of imports in the first year by approximately 578 thousand barrels per day or 211 million barrels per year.
- This reduces the federal import tax collection $2.1 billion dollars a year.
- This makes the nation's oil bill rise by $42 billion dollars in the first year of the tax. The federal government receives only about $9.6 billion per year, with the remainder of $32.4 billion being transferred from American consumers to American oil producers.
- Gasoline prices will rise almost 24 cents per gallon.
- Natural gas well head prices would rise by an equivalent amount.
- Employment will be reduced by over 400,00 jobs.

Other Arguments Against An Import Tax:

Putting aside all of these considerations, there are still other problems with an oil import tax. First, what is the appropriate level for oil prices to ensure adequate exploration and production. The price for domestic oil would need to be set at a level that would, given the risks such as dry holes, equate the rate of return in production to the risk adjusted rate of return in other industries. Any rate below that would reduce the amount of resource committed to the oil industry, thus reducing national security interests. Any rate higher than that would result in an inefficient use of society's resources and a larger shift of wealth from the non oil producing public to domestic oil producers. Additionally, such a tax would result in higher unemployment and inflation than would be necessary to induce oil exploration and production. This is indeed a formidable task.

Once having chosen the appropriate price of crude oil, one is faced with the task of finding the appropriate rate of growth in this price. Failure to do so would result in the aforementioned problems.

Having chosen both the correct crude oil price and the appropriate rate of growth, the policy maker is faced with having to chose the correct amount of tariff or tax to keep domestic prices at this level and to insure that they grow at the optimum rate. Again, one must know the future path of oil prices and the ability of exporting nations to shift the burden of the tax forward.

For example, assume that the optimum price for domestic crude oil is $10.00 per barrel, and that historically there has been a two dollar differential between domestic and foreign crude oil. This means that a tax must stabilize imported crude oil at $12.00 per barrel. If foreign crude is selling at $15.00, then a tax of three dollars may be enough to keep domestic prices at $12.00. This assumes that the exporting nation does not cut its prices in response to the import tax. If it does, then the price of imported oil will continue to decline and this will force domestic prices down. As can be seen the problems with establishing an oil import tax are quite large and may render this as an unattainable goal.

SUMMARY

In summary, PMAA urges Congress to carefully consider all the implications of an oil import tax. We believe you will agree with us that is is bad energy policy, bad tax policy, bad trade policy and bad economic policy. We would be happy to provide the Committee with further information.

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